The Canadian Chartered Accountant

OFFICIAL ORGAN OF

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

Published monthly; subscription $4.00 per annum in advance; single copies forty cents. Advertising rates sent on request.

Articles submitted for publication will be read as promptly as possible, and either retained for use or else returned to the author.

Opinions expressed in articles in The Canadian Chartered Accountant are not necessarily endorsed by the Association.

Authorized as second class mail, Post Office Department, Ottawa.

Publication Office
10 Adelaide Street East, Toronto
R. F. BRUCE TAYLOR, Editor

VOL. LI | DECEMBER, 1947 | ISSUE No. 6

Christmas Message

The Editor has kindly placed at my disposal space for a very brief Christmas message. I am pleased to avail myself of the opportunity to wish to all our readers a full measure of those essentials of a joyous Christmas, good health, happy homes, kind friends and peace in the heart.

Thos. H. Moffet
President.

Editorial Comment

Accounting Terminology

One of our members is so discouraged by what he reads in the financial pages of newspapers that he, sometime ago, came to the conclusion that the only thing he could rely upon was that the financial community at least knew the difference between a balance sheet and a statement of profit and loss. He is now devastated because this last hope disappears when he sees in the financial page of the *New York Sun*, day after day, the following headnote to its statements of company profits—

"These income reports were obtained from news services. Earnings are shown subject to credits and dedeductions which may be disclosed in the balance sheet." Like him, we do not know for how many years the loyal readers of the *New York Sun* have been looking for adjustments to earnings in Companies' balance sheets.

His comment does remind us, however, that we accountants are prone to take it for granted that everyone understands our terminology, and, in all our learned discussions and pronouncements on accounting matters, which of course are not for our eyes alone, we may use words and phrases which are not readily understood by their readers. We should, perhaps, now realize that we are talking over their heads, and embark upon an educational programme covering fundamental definitions.

In any effort in this direction, we shall no doubt find that we ourselves are confused and that we use different terms to mean the same thing. For example, do we agree that *income, earnings, revenues* and *profit* are one and the same or are there shades of difference between them? What is the difference beteewn *working capital* and *liquid capital* —incidentally, why are either of these two entitled to the use of the word *capital?* Where on earth does the title *sinking fund* come from, and how do we expect the uninitiated to appreciate that the larger it is the better off the company is? Or is it?

The Investment Dealers' Association of Canada has taken a leaf from our book in its publication within the last few months of a booklet entitled "Investment Terms and Definitions" (copies may be obtained from the secretary at 24 King Street West, Toronto at 15c each). This is a most useful work and is recommended to all interested in financial affairs. A similar effort entitled "Interpretation of Financial Statements" issued by this Association would be a splendid complement. The two would provide the investor with a basic handbook essential for real understanding of the investment and security markets.

Our Contributors

With the notes on "Current Accounting Literature" which appear in this issue, Mr. F. S. Capon concludes his work in this field. Pressure of business has forced him to relinquish the assignment which he has performed so capably

for some years. His contributions have been a very popular feature of the magazine and, while he is unable to continue it, we hope that he will find time to write articles for us. The thanks of the profession are due to Mr. Capon for good work unselfishly done.

Mr. J. Grant Glassco who contributes the article entitled "The Treatment of Depreciation under The Income Tax Bill" also delivered the address published in the November 1947 issue under the heading "Trends in Post-War Tax Policy". Mr. Glassco is a member of the firm of Clarkson, Gordon & Co. and resides in Toronto. He is first vice-president of the Ontario Institute.

Mr. F. G. Winspear who has written the refreshing article on "Theory and Practice in the Training of Accountants" is senior partner of Winspear, Hamilton, Anderson & Co. with headquarters in Edmonton. He is a member of the Board of Examiners-in-Chief of this Association.

Mr. George Moller, C.A., who has contributed the article on "Certain Accounting Aspects of Provincial Corporations Taxation", is on the staff of George A. Touche & Company, Toronto and is a member of the Ontario Institute. He came to Canada in 1939 from Czechoslovakia, where he had previously attended Prague University and earned the degree of Doctor of Law.

The Treatment of Depreciation Under the Income Tax Bill

By J. Grant Glassco, F.C.A.

The depreciation provisions of the Government's new Income Tax Act as set forth in Bill 454, introduced into the House of Commons last July, are to be found in section 11(1)(a) which provides:

> "Notwithstanding any other provision in this Division, the following amounts may be deducted in computing the income of a taxpayer for a taxation year
>
> (a) such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation."

This general approach is, in the writer's opinion, a distinct improvement over the present Act which provides in effect that no deduction may be made in respect of depreciation except such amount as the Minister in his discretion may allow. While the new provision does not perhaps represent a complete declaration of the entitlement of the taxpayer to a reasonable depreciation allowance, it is to be assumed that the new Act, when read with the regulations to be made under it, will amount to approximately the same thing.

The existing administrative pattern in regard to depreciation reflects the consistent effort made over the past few years to bring about orderly conduct by taxpayers and to prevent gross over-depreciation. However, with the residual effects of "extra" depreciation granted under certificates of the War Contracts Depreciation Board, war-time accelerated depreciation arising from abnormal intensity of use and the double depreciation granted by the incentive legislation of 1943, the drafting of the regulations required under the new Act promises to be a reasonably complicated procedure.

The whole subject of depreciation has acquired a new importance to business as a result of the rise in the price level and its effect upon the problem of financing plant replacements. Further, the substantial increase in the level of taxation of corporate income which has occurred since the beginning of the war has obviously an adverse effect upon

incentive and special tax treatment of depreciation is one of the most effective remedies readily available. For these reasons it seems of the utmost importance that the accounting profession should re-examine the whole question of depreciation and be prepared to give the public and the Government the benefit of its views at this time.

Over the past four or five years the Committee on Terminology of the American Institute of Accountants has been concerned with reaching satisfactory definitions of depreciation accounting and related terms. The definition which the Committee adopted after receiving comments and criticism on earlier drafts from accountants in the United States is published as part of Accounting Research Bulletin No. 22 of May, 1944, and reads as follows:

> "Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation not of valuation. "Depreciation for the year" is the portion of the total charge under such a system that is allocated to the year. Although the allocation may probably take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences."

One of the most important contributions which the Committee has made, in the writer's view, is to make it clear that annual depreciation when used in an accounting sense has no necessary relationship to change or diminution of value arising from occurrences within the year. This view is aptly expressed in the following quotation taken from Accounting Research Bulletin No. 20 (page 166):

> "Much of the confusion and many of the misapprehensions that have arisen in respect of depreciation accounting would, as the Committee's report of last year suggested, be obviated by the substitution of some such word as "amortization" for "depreciation". The use of the latter word to describe a fall in value is so widespread and so well justified by the root meaning of the word that it is unreasonable to expect that the technical accounting use of it will

result in the complete abandonment of the use of the word in the popular sense, even in accounting."

With these thoughts in mind, what then are the aspects of the problem to which accountants in Canada can make a useful contribution?

Cost as a basis for depreciation

The Income Tax administration for many years has consistently limited depreciation allowances to the cost to the taxpayer. The famous Pioneer Laundry case was an attempt by the administration to enforce this rule in a practical but extra-legal manner by denying depreciation to a corporation on assets acquired from a predecessor corporation owned by the same shareholders and in whose hands the assets had been fully depreciated prior to transfer. The failure of this attempt led to the removal of the statutory provision for depreciation from section 5 of the Act headed "Deductions and exemptions allowed" to section 6 headed "Deductions from income not allowed" and later by the enactment of the first proviso to sub-section (n) of section 6. It seems doubtful whether a majority opinion of practising accountants in Canada would be opposed to the retention of some regulatory provision designed to block tax evasion of a most obvious type. But with this, in common with most anti-evasion legislation or regulation, there is a grave danger of unreasonably limiting the freedom of action of legitimate business. It seems to the writer that this is the type of problem which can usefully be studied from an objective point of view by the accounting profession.

In a recent Order-in-Council having to do with double depreciation for rental housing projects there appeared for the first time in Canada a practical application of the principle that the depreciation allowance should be applied to the original cost of the asset, regardless of its cost to the present owner. In effect this means that regardless of the price which a taxpayer pays for one of these buildings, the limit of the depreciation which will be allowed to him will be the undepreciated balance of the cost to the vendor. While such a condition is perhaps not too high a price to pay for the benefits otherwise conferred by this Order-in-Council, the principle involved, if applied in any general manner, would produce consequences of a highly undesir-

able character. It is probably not practically possible to adopt such procedure as part of the general rule, but nevertheless it may be desirable for the profession to express its considered opinion on this phase of the subject.

Maximum rates and imputed service life

There will be general agreement that some of the maximum rates established are generous and have in fact led to substantial over-depreciation: the so-called 80% rule is evidence of this fact. In respect of some classes of assets, however, notably buildings, the maximum rates have not been very liberal.

There has never been any clear-cut statement by the Income Tax administration as to what the allowance for depreciation is supposed to cover. There have been periodic protestations by senior tax officials that it is not intended to provide for obsolescence. If the definitions of the American Institute of Accountants above quoted are acceptable and annual depreciation is to be considered as an allocation of cost over the estimated useful life of the unit, it seems inevitable that the annual depreciation must provide for all the factors which contribute to the ultimate retirement of the unit. It is worth noting that regulations of the United States Bureau of Internal Revenue, dealing with the depreciation allowance, provide that "a reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income." It is suggested, therefore, that we should cease arguing this point and acknowledge frankly that it is impossible as a practical matter, and undesirable in any event, to deal separately with wear and tear, obsolescence and the other elements which contribute to the exhaustion of useful service life.

With regard to property acquired in used or second-hand condition, the administration has so far refused to permit taxpayers to increase the rate of depreciation in recognition of service life exhaustion which has occurred before acquisition. In some cases this has proved a decided hardship and the policy cannot be defended on any grounds but those of expediency: admittedly, the work of the administration will be simplified by refusing to consider evidence which taxpayers may offer in support of a higher depreciation rate in such circumstances. It seems to the writer, however,

that with taxation at its present level, the inequity of such procedure is of sufficient importance to require a change in policy.

Consistency by the taxpayer

The introduction of the 50% rule in 1928 was the first occasion upon which the question arose as to what was the taxpayer's "normal" rate of depreciation. Prior to that time the only concern of the authorities was that the rates written each year did not exceed the maximum rates laid down. But the question of each taxpayer's "normal" rate became of great importance during the early years of the war, when a ruling was made that no taxpayer might increase his normal rate over that written by him during the standard period, even where his standard period rate was below the maximum rates allowed. In the face of a scheme of taxation of excess profits, little objection can be taken to such a general rule, although its rigid application undoubtedly worked hardships in certain cases where taxpayers were justified in increasing depreciation rates for reasons unrelated to the outbreak of war. It is to be hoped that with the abolition of the Excess Profits Tax Act, upward adjustment of inadequate rates will be accepted without question so long as the maximum rates are not exceeded.

Reflection in books of account of depreciation claimed for tax purposes

Since 1932 the administration has recognized depreciation only to the extent that it was set up in the taxpayers' books of account. This policy was initiated at a time when a number of taxpayers had for many years provided no depreciation in their published accounts but had consistently claimed depreciation for tax purposes. To the extent that the ruling was designed to put an end to such an improvident procedure, it is entitled to the support of the accounting profession However, it is becoming apparent that this rule may have some totally unexpected and undesirable consequences The offering to taxpayers of incentives by way of special depreciation allowances creates problems of an accounting nature which are of considerable difficulty and the shackling of the depreciation charge in the accounts to the actual amount claimable for tax purposes permits no freedom of action whatsoever in determining the most ap-

propriate method of stating the periodic income of the taxpayer.

The continued adherence of taxpayers to this rule may well involve a departure from the principle that the method of allocation of cost embodied in depreciation accounting should be systematic and rational. In the framing of regulations under the new Act, therefore, it is suggested that the practical advantages to the tax authorities in continuing to require that taxpayers charge in their accounts the exact amounts of depreciation allowable for tax purposes should be weighed against the difficulties and inconsistencies which may result therefrom in the preparation of statements of periodic income.

Accounting for Retirements

Over the past few years and particularly in respect of those taxpayers who have adopted a policy of depreciating as separate groups the additions of each year, there has developed a problem in connection with accounting for the retirement of fixed assets, principally in the machinery and equipment classifications. This difficulty has its origin in the assumption which is generally insisted upon by the tax authorities that the rate applied to the group also applies to each item within the group. Hence if a unit of equipment which is included in a group carrying normal depreciation at a rate of 10% per annum is physically exhausted at the end of 7 years, it is assumed that depreciation has only been provided to the extent of 70% of its cost; if the salvage value should be, say 5%, the company is therefore deemed to have suffered a loss equivalent to 25% of the cost of the unit. The losses deemed to have been suffered on this line of reasoning are treated for tax purposes as being capital losses and are not permitted as deductions. The result is that a taxpayer which conscientiously retires equipment as it becomes exhausted is at a considerable disadvantage as compared with other taxpayers who, with less regard to the actual facts of the case, defer the writing off of exhausted assets until the expiration of their assumed life.

It seems to the writer that there is a fundamental fallacy in the basic assumption made by the tax authorities with regard to the amount of depreciation provided; the group rate is obviously based upon the average service life

of the group and it follows that within the group there will be assets having lives both shorter and longer than the group average; it follows further that a rate of 10% per annum applied to a group is really equivalent to a rate of 20% on some of the assets within the group, 12% on others, 8% on others and perhaps 4% on others, but in ordinary circumstances there is no information available from which the exact amount provided in respect of a particular unit may be determined.

It is not suggested that the treatment of this problem is exclusively a tax matter, but the fact is that the accounting of taxpayers is influenced by the requirements of the tax authorities. Perhaps the simplest solution lies in admitting that the exhaustion and replacement of plant and equipment in the ordinary course of business does not give rise to profits or losses of a capital nature and permitting the whole cost of the asset, less salvage, to be charged against the depreciation reserve or, in the alternative, continuing to compute "losses" in the manner above described but permitting the amount thereof to be treated as deductions in arriving at taxable income year by year.

Unless some such step is taken, our tax procedures will continue to penalize the conscientious taxpayer who keeps adequate plant records, through offering a tax reward to those who are unable to produce the information necessary to adjust their plant accounts from year to year in a proper manner.

Other Considerations

The foregoing are the more important specific points which arise from an examination of past and present administrative practice but in the preparation of the regulations under the new Act it is suggested that consideration be given to the broader problems of corporate financial policy which are inherent in the present situation.

The first of these relates to the use of depreciation allowances as an incentive. It can, I think, be conclusively shown that the vigour of our economy, as exemplified by our production performance, requires a modern and competent productive mechanism. The first symptom of industrial decay appears when manufacturers fail to keep their plants thoroughly modern and efficient. It is therefore certainly in the public interest that Canadian plants should take

advantage of all improvements resulting from technological changes and that the productivity of labour, equipped with the best in the way of instruments of production, should be as high as that of any country in the world. The force which compels the individual manufacturer to bring about such a state of affairs in his plant is the hope that his expenditures on capital goods today will increase his income tomorrow; but it cannot be denied that the post-war income dollar is a considerably less attractive reward than was available in 1939 and the principal difference is the increase in the corporate income tax. While there may be room for speculation as to the exact measure of the effect upon incentive of a 30% corporate income tax, there can be no doubt whatever that the increase in the tax level from a pre-war 15% has had a profound effect upon incentive. The question must arise in these circumstances whether or not it is in the public interest to stimulate incentive by offering manufacturers an opportunity to depreciate new assets at an accelerated rate.

The double depreciation provisions enacted in 1943 of course did just that, but the conditions under which taxpayers might avail themselves of those provisions were strictly limited and in any event the privilege has now run out. It should be remembered also that the objects which the Government sought to secure through granting double depreciation were only in part to stimulate additions to plant and also included the creation of a demand for capital goods which would breach the conversion from war to peace, with a resultant increase in employment.

An eminent engineer in the United States recently expressed the view that in order to maintain the productive machinery of that country at maximum efficiency it would be good business to permit taxpayers to write depreciation at any rate which they choose. Perhaps this is too bold an approach, but at all events it is a subject which requires the most careful and objective consideration at this time. It should be remembered that the amount of depreciation to be claimed is limited by the cost of the assets, and from an accounting point of view it is required only that the allocation of such cost over the estimated useful life of the unit be made in a "systematic and rational manner". The straight-line method is only one of a number

of systematic and rational methods of allocating the cost. The compound interest, sinking fund, annuity, unit-of-production and fixed-percent-of-declining-balance methods all are other systematic and rational methods. What this suggests is that it may be desirable to adapt one of the existing methods, or even develop a new one, with the object in view of securing the maximum stimulus to maintain our national productive efficiency.

No discussion of these problems would be complete without a reference to the financial problems facing manufacturers in the replacement of plant at price levels very substantially above those at which the original plant was acquired. The price index (D.B.S. index of wholesale prices in Canada) in August 1947 was some 70% above the 1939 level and when the effects of the relinquishment of price controls are fully reflected, it is not beyond the bounds of possibility that the index will stand at double the pre-war figure. The history of the last war is that during and shortly following the war prices rose more than 100% and, after a disastrous decline in the prices of all principal commodities, the general level settled down to a point approximately 50% above the 1913 level. Whether that pattern is to be repeated or not, there are no grounds for the belief that we shall permanently return to pre-war price levels.

If for these reasons manufacturers face the necessity over the next few years of replacing worn out and obsolete plant at this higher price level, the capital investment is bound to increase and unless this problem is faced squarely it is bound to have some very unpleasant consequences. The difference between our present tax rates and those in force in the 1920's may be sufficient to tip the scales against the business which makes no special provision for this requirement; and the danger we face in such circumstances is unjustified borrowing creating a burden of debt which cannot be supported through a period of subnormal business activity.

This problem is engaging the attention of the Committee on Accounting Procedure of the American Institute of Accountants and on September 25, 1947, a letter was written to the members of that body pointing out the problem and giving certain tentative conclusions. The state-

ment of the committee is of considerable interest and is reproduced hereunder.

" The American Institute of Accountants committee on accounting procedure has given extensive consideration to the problem of making adequate provision for the replacement of plant facilities in view of recent sharp increases in the price level. The problem requires consideration of charges against current income for depreciation of facilities acquired at lower price levels.

" The committee recognizes that business management has the responsibility of providing for replacement of plant and machinery. It also recognizes that, in reporting profits today, the cost of material and labor is reflected in terms of 'inflated' dollars while the cost of productive facilities in which capital was invested at a lower price level is reflected in terms of dollars whose purchasing power was much greater. There is no doubt that in considering depreciation in connection with product costs, prices, and business policies, management must take into consideration the probability that plant and machinery will have to be replaced at costs much greater than those of the facilities now in use.

" When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels.

" It has been suggested in some quarters that the problem be met by increasing depreciation charges against current income. The committee does not believe that this is a satisfactory solution at this time. It believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level. An attempt to recognize current prices in providing depreciation, to be consistent, would require the serious step of formally recording appraised current values for all properties, and continuous and consistent depreciation charges based on the new values. Without such formal steps,

there would be no objective standard by which to judge the propriety of the amounts of depreciation charges against current income, and the significance of recorded amounts of profit might be seriously impaired.

" It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

" The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels. However, the committee calls attention to the fact that plants expected to have less than normal useful life can properly be depreciated on a systematic basis related to economic usefulness."

There will undoubtedly be some who would dissent from certain of the conclusions set forth above but it is beyond the scope of this article to discuss the merits of this submission. What is of particular interest so far as depreciation policy is concerned is the fact that some suggestion has been made that the problem be met by increasing depreciation charges against current income by adjusting the basis for depreciation upward from the actual cost. The committee on Accounting Procedure of the American Institute of Accountants has rejected this as an appropriate solution for the reasons stated. It is, however, not unreasonable to suggest that, in considering what latitude may properly be given to Canadian taxpayers in selecting a depreciation method, due weight should be given to the fact that they face a financial problem of unusual difficulty.

Depreciation accounting, as such, has come over the years to be almost universally accepted as the best method of making charges to operations in respect of the cost of plant and equipment used or to be used in producing income. It should not, however, be assumed that no combination of circumstances can arise which would tend to change the whole process of accounting thought in this

connection. For example, those who have consistently proclaimed the soundness of renewal accounting for an enterprise that has reached maturity are placed in a much stronger position by current developments. A great deal of serious thought and research is being devoted to an examination of the inventory concept of fixed plant and the desirability of applying to it some such treatment as the "LIFO" method accords inventory changes. It seem to the writer, therefore, unwise to assume that there is any phase of this problem upon which we need expend no more thought: it is suggested that when the profession comes to express its views in connection with the new income tax legislation, such views should be based upon the most careful consideration of the broad aspects of the question and not simply directed to the improvement of administrative practice as we have known it.

Photos of Past Presidents

The Dominion Association of Chartered Accountants has arranged for the grouping of the photographs of the past-presidents of the Association. These may be obtained through the secretary's office in either black and white or sepia at $1.00 each, unmounted and are approximately 7½" x 9" in size.

The first group contains the photographs of John Hyde, William H. Cross, A. W. Stevenson, John Mackay, A. F. C. Ross, Henry Barber, A. F. Riddell, George Edwards, W. A. Henderson. The second group contains the photographs of E. Kaulbach, A. Shaw, O. J. Godfrey, D. A. McCannell, John Parton, A. C. Neff, George E. Winter, H. D. Creighton, B. R. Masecar, and A. E. Cox. The third and fourth groups, which will be ready in the near future, will contain the photographs of J. B. Sutherland, E. Trudel, E. S. Read, H. P. Edwards, G. F. Gyles, H. E. Crowell, G. C. Rooke, F. M. Harvey, G. C. McDonald, J. G. Mundie, and H. E. Guilfoyle, A. B. Shepard, F. A. Nightingale, W. E. Hodge, K. W. Dalglish, W. S. Rowe, M. C. McCannell, K. A. Mapp, H. G. Norman, F. Johnson.

It is proposed that further groups will be prepared at decennial intervals.

Comments on Current Practice

By Clem L. King, C.A.,
Secretary and Director of Research
The Dominion Association of Chartered Accountants

EDITOR'S NOTE:—From time to time it is our intention to publish notes prepared by Clem L. King, C.A., in his capacity as Director of Research of the Dominion Association of Chartered Accountants, on various matters arousing his interest as he carries on his work. The logical outcome of these duties over a lengthy period will be the issuance of pronouncements by the Accounting and Auditing Research Committee. Before this final stage is reached, however, it would seem useful to throw open Mr. King's thoughts for public review. It is emphasized that these notes are not to be considered as pronouncements or official releases of the Association or of a Committee of the Association. Mr. King hopes that these periodic and, perhaps spasmodic, invitations will be accepted by many readers and that they will put forward their views as informally as he has put forward his. The replies received will not necessarily be published and in any event no reply will be published without preliminary discussion with the writer.

THE ACCOUNTING TREATMENT OF CERTAIN INCOME TAX ITEMS

SECTION 5, subsection 1, paragraph p, of the Income War Tax Act provides that the profits of the year may be reduced, under certain conditions, by the losses of the three preceding years and the next succeeding year. As a result of this provision, there will be instances in which the tax liability as previously estimated will be altered, and, in some instances, claims for refund of a portion of the taxes already paid will arise. In addition to cases arising under the above-mentioned provision of the Act, numerous instances occur in which, for one reason or another, previous estimates of the amount of the tax liability of previous years must be altered. The question of reflecting such adjustments in the financial statements, particularly the profit and loss statement, is important since in many instances the net profit after taxation will be materially altered and the liability for, or anticipated refund of, taxes will constitute a material proportion of the current liabilities or assets.

Adjustments Under Section 5(1)p

Where the application of Section 5(1)p results in a reduction of the tax liability or a claim for refund of taxes already paid, the question arises whether such reduction

should be treated as applicable to the year or years of profit or to the year or years of loss. In the preparation of financial statements, recognized accounting practice dictates that profits or gains should not be anticipated, nor need provision be made for expenses or losses which cannot be foreseen or anticipated as at that date. It is axiomatic that all businesses anticipate operating at a profit, else they would not attempt to continue activities. Therefore, in the estimation of the tax provision for the year under review, when the operations of that year have resulted in a profit, the provision cannot be reduced on the basis of an assumption that in the next succeeding year the operations of the business will be carried on at a loss, which can be carried back to reduce or eliminate the profit of the year for tax purposes. In the estimation of the tax liability or claim for refund in respect of the year under review, when the operations of that year have resulted in a loss which is greater than the profit of the preceding year, the amount of the reduction in the tax liability or of the refund cannot be determined on the basis of an assumption as to the probable results of succeeding years' operations, but must be calculated on known events to that date.

In the former instance the profit and loss statement should show the amount of the tax liability in respect of the year's operations, and as a separate figure, if the amount is material, the reduction in tax liability resulting from the carrying forward of the losses of previous years. There could have been no reduction because of prior years' losses unless the year's operations had resulted in a profit. It is not permissible to anticipate profits or gains, so recognition of the reduction cannot be made until the year of profit following a year or years of loss, or until the year of loss following a year of profit, upon which the tax has already been provided.

In respect of the latter instance, the profit and loss statement should show as a separate figure, if the amount is material, the amount of the reduction in tax liability and/or of the refund claim.

Adjustments Relating to Prior Years

Of a number of accounting texts reviewed, most authors take the view that the profit and loss statement should not include adjustments of the income estimates of prior years,

but that these items should be carried directly to surplus. However, there is a growing feeling, which is more apparent in the United States than in Canada, that the profit and loss statement should record all revenues and expenses, gains and losses, and other items and transactions except those arising directly from capital stock transactions or dividends. While it cannot be said that many authors of accounting texts agree to this treatment, some do, and a number recognize the trend. The Accounting Research Committee of the American Institute of Accountants definitely recommends that all items be included in the profit and loss statement.

The conflict between the two points of view is almost a fundamental one. Those who desire all transactions to be recorded in the profit and loss statement claim that the statement is at best a considered estimate of the operations of a short period, but since it is an historical document, it should show all operations of the business and not omit some merely because knowledge gained at a later date indicates that the original allocations were in error or because they happen to be "unusual or non-recurring". They claim that the reader of the statement is entitled to see all items going to make up the accumulated profits from year to year as they become apparent and, further, any attempt to exclude so-called "extra-ordinary" items from the current statement tends to produce a figure for net profit which might be regarded as "normal" or "usual". They insist that most business operations are subject to wide variation and any attempt to level these by artificial methods is misleading.

The other group takes the view that the average investor or prospective investor is interested in reading the statement to determine the probable rate of return on his investment from the ordinary recurring operations of the business, and usually on a short term basis. They claim that it is misleading to include items in respect of prior years operations and extraordinary items in the current profit and loss statement since they distort the final figure of Net Profit.

Canadian Practice

Canadian practice is unsettled at present. A number of published statements were reviewed and out of 104 state-

ments selected at random, 50 had items in the profit and loss statements or surplus statements relating to prior years transactions. Four classes of adjustments were analysed as follows,

a. 24 items were adjustments of taxes of prior years, 4 of which were recorded in the profit and loss statement and 20 in surplus.
b. 5 items were in respect of the renegotiation of war contracts, 1 of which was entered in profit and loss and 4 in surplus.
c. 21 items were sundry adjustments, 4 of which were entered in profit and loss, and 17 in surplus.
d. 29 items were in respect of profits or losses on the disposal of fixed assets and/or securities, 15 of which appeared in profit and loss and 14 in surplus.

Trend in Practice

It is apparent that present practice places adjustments of taxes of prior years in the surplus account, but opinion appears to be equally divided as to the treatment of profits or losses on the disposal of fixed assets and securities. It is difficult to see why, if the profit or loss on the disposal of a fixed asset is to be included in the profit and loss statement, adjustment of the estimate of prior years' taxes should be excluded.

The trend appears to be towards placing such tax adjustments in the profit and loss statement, but such treatment is by no means as common in Canada as it is in the United States. Perhaps the answer at the moment is to place them in the profit and loss account, unless they are so material in amount that their inclusion would make the statement misleading, in which case they could be placed in the surplus account, with a notation as to the action taken being placed on the profit and loss statement, unless the two statements are presented in such a manner as to indicate clearly the treatment adopted.

Statement of Earnings for a Prospectus

In the preparation of a statement of earnings for a prospectus all material adjustments of taxes should be allocated to the years to which they apply. As a matter of practical expediency so far as such a statement is concerned, and because the tax concession was originated to cushion the impact of loss years, it would appear that years

of profit should bear the normal tax burden applicable to that amount of profit at that time, and that years of loss should be credited with the amount of the saving in tax payable resulting from the operation of Section 5(1)p.

The following table illustrates the effect of the treatment suggested:

Year	1	2	3	4	5	6	7
Profit (before tax)	$1,000			$750	$1,500		$1,400
Loss		$500	$1,000			$500	
Tax (at 30%)	300				375		420
Tax Refund		150				150	
Net Profit (or Loss) as per Statement	$ 700	$(350)	$(1,000)	$750	$1,125	$(350)	$ 980

In year 2 the loss of $500 was, for tax purposes, carried back against the profit of year 1 and a reduction of $150 in the amount due in respect of year 1 was thereby obtained. In year 4 $750 of the loss in year 3 was brought forward, eliminating any taxable income for year 4. In year 5 the remaining $250 of the loss in year 3 was brought forward, reducing the taxable income to $1,250. In year 6 the loss was carried back against year 5 as in the case of year 2.

For the purposes of the statement of earnings for a prospectus, the net figures for the various years would be adjusted to the following:

Year	1	2	3	4	5	6	7
Net Profit	$1,000			$ 750	$1,500		$1,400
Net Loss		$ 500	$1,000			$ 500	
Tax	300			225	450		420
Tax Reduction		150	300			150	
Net Profit (or Loss)	$ 700	$(350)	$(700)	$ 525	$1,050	$(350)	$ 980

Claim for Refund of Taxes Paid

In ordinary circumstances a claim for refund of taxes paid should not be regarded as an asset until the Tax Department has assessed the returns in question or admitted the claim. In the case of a claim for refund arising under the provisions of 5(1)p however, the amount of the refund can be determined in accordance with the provisions of the Act with at least the same degree of accuracy as taxes payable. It is anticipated that the Income Tax Department will soon reach the position where the returns of each year are assessed within a twelve month period. On

the assumption that there is reasonable expectation of receiving any refund within a year, there is no reason why the amount of the refund should not be treated as a current asset. If there are special circumstances which make it probable that it will be more than a year before the refund is received, the amount of the refund should not be regarded as a current asset unless it is of immaterial amount.

The claim for refund should be stated as a separate item in the current assets unless it is of immaterial amount. Naturally, there will not be any item for a claim for refund if there is an overall tax liability.

Deferred Asset

Post War Refund of Excess Profits Taxes

The amount of the post-war refund of Excess Profits Taxes is presently treated as a deferred asset, the offsetting credit being regarded as part of Surplus, or as a special segregation of Surplus under the title "Deferred Surplus".

The necessary Orders-in-Council have been issued whereby the refund in respect of fiscal years ending in 1942 is to be paid during the fiscal year ending 31st March 1948, and the refunds in respect of succeeding years will be paid accordingly.

The Committee on Accounting and Auditing Research has already gone on record (Bulletin No. 1) as recommending that current assets include only cash and other items which it is expected will be reconverted into cash within one year. There does not appear to be any good purpose to be served by altering the stand so taken. Therefore it would appear reasonable that as a portion of the post-war excess profits tax refund becomes collectible within one year, that portion should be moved to the current asset section, and if significant in amount, be shown as a separate item.

Deferred Surplus

The justification for crediting the amount of the post-war refund to Deferred Surplus was the desire to account for such amounts on a cash basis, having in mind the uncertainty as to the date of the refund. Following this basis through, the logical basis to use in closing the amount to the regular Surplus account is to transfer as received only those amounts actually refunded. In this circumstance the transfer to Current Assets of that portion which becomes

refundable within a year is in opposition to the stand that such amounts should be accounted for on a cash basis. It would appear that the practical remedy is to transfer the Deferred Surplus to the regular Surplus account immediately.

Statement of Earnings for a Prospectus

In the preparation of a statement of earnings for a prospectus, the income taxes in respect of the various years in which the Excess Profits Tax applied should be shown as the net amount applicable to each year, i.e., the gross tax payable less the refundable portion. This is the practice presently being followed in prospectuses which have been issued during this past year.

AMERICAN INSTITUTE SIXTIETH ANNUAL MEETING

In welcoming the members on November 3-6, to the sixtieth annual meeting of the American Institute of Accountants at Miami Beach, Florida, the President, Mr. Edward B. Wilcox of Chicago, pointed out that the program was designed to "afford an opportunity to review what the accounting profession has accomplished in three score years and to appraise today's challenges to the accounting profession."

Among the speakers addressing the various sessions, which were informative and interesting, were Donald R. Richberg, former N.R.A. Chairman, who spoke on "Accounting Aid in Labor Management Relations"; Stuart A. Rice, Assistant Director in charge of Statistical Standards, Bureau of the Budget, Washington, D.C., who spoke on "Use of Accounting Data in Economics and Statistics"; Hon. James J. Caffrey, Chairman of the Securities and Exchange Commission, who outlined the Long-Range Objectives of the S.E.C.; Roswell Magill, New York attorney, who spoke on "The Federal Tax Outlook", and Hon. John Taber, Chairman, Committee on Appropriations, House of Representatives, who spoke on "The Government of the United States."

The Florida Institute of Accountants, taking advantage of the material facilities provided by their state, extended the warm hand of hospitality to the visiting members and made their stay extremely enjoyable.

The Dominion Association of Chartered Accountants was represented by Thomas H. Moffet, President, and Clem L. King, Secretary.

Certain Accounting Aspects of Provincial Corporations Taxation

By George Moller, C.A.

The purpose of this article is to draw attention to some of the difficulties arising from the re-enactment of provincial taxation on corporations. It is beyond the scope of the public accountant to deal with the political aspects of the question, and therefore, the situation will be considered from the viewpoint of the legislation already enacted and its authoritative interpretation without regard to the requirements of efficient taxation.

After the termination of the wartime agreement with the Dominion of Canada whereby the nine provinces had vacated the income tax field to the Dominion for a period which ended the 31st March 1947, the provinces re-enacted legislation in the beginning of 1947 which imposed a tax on profits of corporations only, in all the provinces. This taxation did not affect the man in the street but created a number of problems for the accountants of incorporated companies.

Seven provinces agreed with the Dominion and their legislation followed a common pattern, laid down in a model act appended to the new Dominion Provincial Agreement. The agreeing provinces imposed a tax of 5% on the income of the corporations whereas Ontario and Quebec, the disagreeing provinces, taxed corporation profits at the rate of 7%. Apart from the profits tax, Ontario and Quebec imposed a capital and place of business tax on the corporations in their jurisdiction.

All provincial corporations income tax acts show the intention of avoidance of double taxation by giving credit to the taxpayer for provincial income tax paid to other provinces. For this reason, the legislation of the non-agreeing provinces assumes a greater importance as their rate of 7% overrides that of the agreeing provinces.

The re-enactment of provincial profits taxes appears to be a step backwards from the viewpoint of administration and efficiency as it imposes an added burden on the tax-paying corporation, which has to file additional returns and has to keep additional records supporting these re-

turns (e.g. distribution of sales according to provinces, etc.)

In addition to this added burden, there are differences in the definitions of the corporation tax acts of agreeing and disagreeing provinces. The table on page 345 illustrates the differences.

Ontario and Quebec apparently try to bring within the scope of their taxation as great a portion of the profits as possible by allocating to the province as many transactions as possible. For this purpose, they consider any corporation as doing (transacting) business in Quebec (or Ontario) which has a person residing in the province acting as an employee, agent, representative or in any other capacity (Section 30 of the Quebec Corporations Tax Act, similar Section 1(o) of the Ontario Act), this without regard whether the person has the power to accept orders or only functions as intermediary between customer and selling corporation without any authority to accept orders on the corporation's behalf. If a corporation has such a person in its employment not only the business acquired or transacted through this person in the province forms the basis of taxation but any business transacted with customers residing in the province becomes a basis for profit allocation. There was considerable doubt under the legislation which was in force before the wartime agreement whether this far-reaching definition of "doing business" was intra vires of the legislating province. It seems obvious that where the actual transacting of business takes place outside of the tax-imposing province the legislation of this province cannot drag it into its orbit by extending the meaning of the words employed beyond their usual limit. It remains to be seen whether any of the corporations concerned will find it worthwhile to challenge the provincial rights of imposing taxation by such rather far-reaching interpretations of "doing business." With regard to the material unimportance in the total tax payable there is almost no inducement to fight the issue.

At present, we have only a "treatise" by the Comptroller of Provincial Revenue of the Province of Quebec, Mr. G. H. Shink, K.C., reproduced in C.C.H. Canadian Tax Reporter which explains the meaning "Doing business in Quebec," on page 346:

OF CORPORATIONS (OTHER THAN BANKS, INSURANCE, RAILWAY COMPANIES, ETC.)

Ontario

Form C T 23—1947

Tax at 7% on the net income of the company *less* dividends received and if head office outside Ontario *Less* income from other investments.

Every incorporated company which has its head or other office in Ontario or which holds assets in Ontario which transacts business in Ontario shall pay this tax calculated upon the net income of the incorporated company whether derived from sources within Ontario or elsewhere.

The amount of the net income deemed to have been derived from sources within each province, state or country shall be that portion of the total net income (exclusive of income from investments, in shares, bonds and obligations of other incorporated companies, governments, etc.) which the gross revenue received from customers residing in each such province, state or country (with the aforementioned exclusions) bear to the total gross sales made or gross revenue received (with the same exclusions) provided that where to the satisfaction of the Provincial Treasurer the net income earned in Ontario and each other province, state or country is capable of accurate determination the actual amounts shall be determined and taxed.

Quebec

Taxable net profit *less* dividends received from other incorporated companies (Order-in-Council No. 1498 changing par. 2 of sec. 7 of the Corporation Tax Act) = net profit subject to allocation

$$\text{X} \quad \frac{\text{Sales in province}}{\text{Total sales}}$$

taxed at 7%.

Form C17

Every incorporated Company having its head office or its principal place of business for Canada in the Province of Quebec.

Net profit subject to tax *less*: taxes paid to other provinces but not more than 7% of profit allocated to other provinces on above mentioned basis.

Form C18

In the case of a company having its head office and its principal place of business for Canada outside the Province of Quebec and having therein a resident representative, agent, salesman or employee; all sales made to, and all revenue received from customers resident in this province shall be considered as having been made or received in Quebec, whether made or received directly by the company or through its representative, agents, etc.

Agreeing Provinces

Form TP 2—1947

Tax at 5% on income subject to tax *less* losses in prior years deductible *less* interest from provincial bonds, etc. issued free of provincial tax.

If corporation has no permanent establishment outside the province in which its head office is located, the whole of the income of the corporation shall be attributed to its operations in such province.

If a corporation has no permanent establishment in a particular province, *no* part of its income shall be attributed to its operations in such province.

An employee or agent who has general authority to contract for the corporation or has a stock of merchandise from which he regularly fills orders which he receives, such agent or employee shall be deemed to operate a permanent establishment of the corporation.

The income to be attributed to the operation in a province shall be determined on the basis of separate accounts pertaining to its permanent establishment in such province, rectified by the Minister under the assumption that the permanent establishment were operated by an independent person. If not so ascertainable a portion of the income shall be attributed to the permanent establishment in a province based on the average of the following ratios:

(a) gross revenue of establishment to gross total revenue of corporation and

(b) gross salaries and wages paid in permanent establishment to total salaries and wages.

"An Ontario company who has an employee or agent resident in Quebec and taking orders for goods there is subject to the tax on revenue. The fact that this company has no office or warehouse facilities does not enter into consideration.

"The company is called to pay a tax on its net revenue in the proportion of its Quebec business. The proportion of business considered to be done in Quebec is in relation of sales made to residents of Quebec to total sales. Sales made to residents in Quebec include not only the sales obtained through an employee or agent, but also sales made to Quebec residents through telephone, telegram or mail. However, if a company has no employee or agent in Quebec and does its sales through telephone, telegram or mail, said company is not considered doing business in Quebec. The essential condition is its presence in Quebec through an employee or an agent."

This authoritative interpretation indicates that Quebec at least will use its taxing authority as widely as possible.

There is another serious difference between the agreeing and disagreeing provinces in the formulae for allocating profits as illustrated in the foregoing table.

Ontario and Quebec will allow tax paid in other jurisdictions only to the extent of the tax actually paid and provided the claimed amount is not in excess of the tax which would have been paid under the Ontario or Quebec Act. The different formula for allocation of profits may easily produce situations in which the tax-paying corporation in spite of the lower rates imposed by the agreeing provinces will have to pay to one or several of the agreeing provinces more than Ontario or Quebec will be prepared to acknowledge as a deduction from the taxes imposed by these provinces.

Form TP 2-1947, page 2 (column 10(2)) shows that the agreeing provinces allow the deduction of losses in prior years presumably to the same extent as for Dominion income tax. Nothing in the Ontario or Quebec statute or forms indicates that these provinces will make the same allowance. It may be assumed therefore that losses in previous years will not be deductible from profits in computing net taxable income in Ontario or Quebec.

If the non-agreeing provinces should decide to disallow special depreciation, granted by the Minister of National Revenue under Section 6 (1) (n) (i and ii), this would involve the necessity of recalculating the net profit of many corporations taxable in Ontario or Quebec and of keeping separate memorandum records of all assets subject to double depreciation. Consistently the provinces would have to allow further depreciation on plant or equipment built or acquired to fulfil orders for war purposes which had been acceleratedly depreciated for Dominion income tax purposes during the war. It remains only to hope that the non-agreeing provinces will not apply the aforementioned interpretation in exercising their taxing authority.*

These possibilities may give the question whether a corporation is taxable in the non-agreeing provinces material importance at a time when the corporation will have established a precedent by having filed returns there.

It should also be considered that the filing of a provincial tax return could be taken as admission of doing business in this province and lead to the demand for taking out an extra-provincial license which in turn necessitates the annual filing of information returns to the provincial secretary.

The amount of tax payable to each province will not be definitely ascertainable due to the various possible interpretations of the different sections of the provincial acts. It will in many cases take a number of years before the liability will be finally determined by assessment and in the meantime there will be one more estimated liability on the balance sheets of corporations which will lead to surplus adjustments and keeping of complicated records. Quebec has already advised the tax paying corporations to leave the right hand column of page 4 of Form C17 blank if the 5% tax payable (to the agreeing provinces) cannot be ascertained or has not yet been paid and to advise the Corporation Tax Office in Quebec as soon as the amount of tax payable is determined. Whether that means that Quebec will allow the maximum allowance on sales basis

*NOTE:—In the meantime information has been received from The Ontario Provincial Treasurer's Department—Corporation Tax—that the Province will normally allow double depreciation recorded in the accounts of a Corporation if and as allowed by the Dominion.

until the tax actually paid will be determined and proven by submitting certified copies of receipts for the taxes paid to each other jurisdiction (as required on page 4 of Form C 17) has not yet been clarified.

The accountant's work is further complicated by the different requests for instalment payments on account of the provincial taxes. The agreeing provinces are keeping their collection in line with the Dominion Government; Ontario and Quebec demand payment of half the estimated tax at the end of the fiscal year for which the tax is payable, the balance on the 15th day of the third month following the fiscal year end, any further payment with the filed return i.e., four months after the fiscal year end in Quebec and six months in Ontario. Ontario and Quebec have issued information sheets and the taxation division of the Department of National Revenue which administers the corporations tax for the agreeing provinces, has just issued information and instructions about the Corporations Income Tax Act. Although the taxpaying corporations should be making their instalment payments in the meantime to avoid interest payments (which are not allowable as expense) the issued regulations have postponed the instalments only for the following: (a) for those the fiscal year of which ended before Royal Assent has been given to the act of the province concerned and, (b) for corporations the fiscal year of which ended less than 6 months after Royal Assent has been given to the act. In the latter case the postponement concerns only those instalments which came due before the act received Royal Assent. For all other corporations this means the e.g. in Manitoba, (the act of which received Royal Assent on the 26th April 1947) a corporation which has its fiscal year ending on or after the 27th October 1947 should have started to make instalment payments in May 1947. It is obvious that many corporations will have failed to realize this obligation and it can only be expected that no interest penalties will be exacted for failure to make instalment payments in the first months after the re-imposition of the provincial acts in the agreeing provinces.

Last, but not least, Ontario and Quebec are re-imposing tax payable on capital and for offices and places of business. Ontario is prepared to deduct the tax paid in other

jurisdictions on capital on a pro rata basis. Quebec professes to be intending to do the same but does not give relief directly on a pro rata basis by statute, subjecting every extra-provincial corporation to an application for relief which will be granted by individual Order-in-Council for each corporation. This appears to be a rather arbitrary procedure which does not fit well into modern taxation doctrines. Apart from the fact that the rate Quebec is exacting is double the rate Ontario demands, the aforementioned feature might easily lead to double tax on the same capital and creates a further uncertainty which will prevail in the accounts of all corporations subject to this taxation, although information given by Quebec asserts that the proportion of the capital tax payable will be based in practically all cases on the ratio of Quebec sales to total sales and that it is therefore not necessary for these companies to wait until they are assessed before making payment of the capital tax.

In connection with the capital tax which has to be paid to Quebec for the period from the 2nd September 1947 to the 30th April 1948 based on 1946 capital, Quebec requires complete financial statements for 1946. Ontario will assess capital tax on the basis of 1947 accounts which complicates the calculation of the proportion to be allowed for Quebec and vice-versa.

Theory and Practice in the Training of Accountants

By F. G. Winspear, C.A.

"The question is," said Alice, "whether you can make words mean so many different things."

Wherever accountants meet, at conventions, at committees, at clubs, or in "bull" sessions, this question of theory and practice in the training and the practice of accounting seems inevitably to arise. "It was a good practical paper", says someone referring to an examination paper. "He is inclined to be a theoretical sort of duck," says someone referring to a fellow member. Theoretically the idea is all right, but in practice it would not be useful," says someone else. "I tell my students that book knowledge can take them only so far; they must have a practical attitude of mind to make successful accountants," is another comment.

Sometimes in these discussions I seem to detect a curl of the lip, a restrained gesture of contempt when theory is mentioned. "It is all right, of course, something one has to have in the early stages before one has gained experience and obtained the broadening influence of practice, but it is probably just as well to forget about theory as soon as possible. Practice is real accountancy; theory is something with which university professors and academicians are concerned. The man of affairs should rise above such nebulous concepts."

Before considering the relationship of theory to practice and the place which both occupy in the training of accountants, and in the practice of accountancy, it is necessary to define with some exactitude just what we mean by the two terms. Sometimes by direct question, sometimes by listening carefully to ideas and pronouncements in accounting discussions, I have endeavoured to clarify in my own mind the sense in which the two terms are ordinarily used. It is unnecessary to refer to the dictionary definitions of the terms, though this might be helpful. I am concerned with the connotation, the sense placed on the terms "theory" and "practice" when accounting methods and conventions, and when student training and examina-

tions are discussed by accounting practitioners. Here then are a number of propositions which I offer for discussion.

Proposition 1

Practice is the amplification of book knowledge by the broadening influence of experience. A practical accountant, therefore, is one who, possibly having attained a certain measure of book knowledge in his early years, now relies almost wholly on the wealth of circumstances and cases which he has himself experienced. It is knowledge gained by actual experience rather than from generalities expressed in the written word.

"Is every circumstance experienced by such practitioner practical experience within your meaning?" one asks. "Oh, yes," the reply is obvious. "Every single experience in the realm of accounting tends to broaden one's mind and to increase one's value." "Such a man must be careful" is suggested (rather sarcastically) "never to express his experiences in the form of an article or a text book, otherwise he would become a theorist." "Not at all" the advocate of Proposition I hastens to reassure. "On the contrary, it is his professional responsibility to give his fellow members the advantages of his experience by occasionally writing articles for professional publications such as the CANADIAN CHARTERED ACCOUNTANT."

"It is quite impossible," it is suggested, "for a young chartered accountant to be a practical accountant within the sense in which you use the term." "Oh no, not at all" is the reply. "Some students have the advantage of being trained under men of broad experience and wide practice. Furthermore, some students tend to have a practical attitude, they possess common sense, they have a capacity to think incisively and directly. In the result, they are practical accountants almost from the outset, or, if not, they become practical accountants very rapidly indeed."

Proposition 2

Theory is that great body of fundamental principles and conventions which underlie a science. Unfortunately, due to agencies external to the profession, it is often necessary to modify such principles in actual practice. Income for income tax purposes, as Stikeman points out, is an artificial concept, having little or no relationship to generally accepted accounting principles. Other statutes, regulations, in-

come tax rulings and so on, require accountants to do things which, if they had complete independence of action, they would not do. Practice, therefore, is a modification of principle.

To the exponent of this proposition one may well ask: "Is practice the failure of the profession to direct thinking in the particular field in which accountants are expert?" The answer might well be that to a certain extent this is true, that persons having rather a primitive concept of accounting technique have tended to dominate legislation and government regulation with the result that accountants, in complying with the law or otherwise adapting themselves to public requirements, have been forced to compromise their own principles.

Proposition 3

Theory is the discursive aspect of accountancy, whilst practice is the tabular or wholly statistical aspect. This proposition is implicity contained in certain examination papers. The University of Alberta, for instance, offers papers in accounting theory to students in commerce, as distinct from papers in accounting practice. Some years ago the Alberta Institute habitually set papers on the same basis—accounting theory and accounting practice, and I believe I am correct in saying that this procedure is still quite common to boards of examiners. A careful examination of the papers would indicate that both the theory and practical papers require a knowledge of the same conventions or principles, and that the difference between the two is simply the form which the answers are expected to take. In the practical papers the student is expected to place his answer in tabular form—balance sheets, profit and loss accounts, statements of application of funds, reconciliations, analyses and so on. In the theory papers he is expected to be discursive and write essays or compositions, even to express his views in the form of generalizations.

Proposition 4

Theory is something new and untried, whereas practice is something old, experienced and accepted.

Proposition 5

Practice is knowing how. Theory is knowing why. This proposition was made to me by a thoughtful senior

student. I have heard it expounded at greater length by university professors and other representatives of academic circles. The distinction between theory and practice, they say, is analogous to the difference between the man of thought and the man of habit. All vocations tend to have their techniques and habits. In the manual vocations and the trades, habit or technique tends to dominate the process. A ditchdigger is a good ditchdigger because he has acquired the habit of doing things in a certain way, so has a parcel wrapper, a carpenter, a bricklayer or a plumber. Theory is the application of rational thinking to the process of doing. The engineer, as distinct from the plumber, does not do things, no matter how technically skilled he may be in doing them, until he has first satisfied himself through intellectual processes that the procedure will comply with certain basic principles. The same is true of the doctor and the lawyer, and the same, it is hopefully suggested, is true of the accountant. To the advocate of this proposition, theory is really the professional determinant, the higher or intellectual phase of the profession, as distinct from manual activity. Theory is thought, and practice is habit. Theory is philosophy, whilst practice is technique.

Possibly the reader will find all these propositions unsatisfying. I do myself. Possibly he regards the terms theory and practice in a wholly different sense, and would wish to advocate wholly different propositions. If that be so, it only tends to substantiate my impression that the professional lacks clarity in just what it means by the terms and the sense in which they are or should be used.

"When I use a word," Humpty Dumpty said,
"it means just what I choose it to mean—
—neither more nor less."

Certainly, with all the confusion obtaining, there would seem to be two roughly discernible schools of thought with respect to theory and practice:

(1) That theory is something which should be regarded, if not with contempt, at least with suspicion.

(2) That practice is technique, and theory is truth and idealism.

A careful examination of the five propositions above suggested (and I still think that they are fairly represen-

tative of the broad thinking of Canadian accountants) would seem to indicate that the terms theory and practice are used in many and varied ways, some diametrically opposed. Proposition 1, for instance, is wholly opposed to Proposition 2. The first suggests that theory is nebulous and unrealistic, that accountancy must of necessity be practical and that the real accountant is therefore wholly a man of affairs and experience. Practice is truth, and theory is postulate. The second proposition, on the other hand, regards the modification of theory by expedient as the failure by the profession to guard its principles from the depredations of the lay man. Theory is truth, practice is compromise.

The third proposition is possibly the most amazing of all. It implies that the moment a thought becomes written it is theory, and before it became written it was practice. Even the most superficial examination tends to discard such a statement. Unquestionably current experience is a great stabilizer, but no profession can afford lightly to abandon the accumulated experience of the past. Assume that a young accountant having read, considered and pondered the fundamental conventions or principles upon which accounting is based finds circumstances in actual experience and practice which cause him to modify his views The articulation of expense with income, for instance, is an accounting principle. Doing things in the way the text book suggests is not, he finds, the best method of implementing that principle. Is not it his duty to make this experience available to the profession as a whole? How else can he do it except by the written word? He would naturally have hesitation in doing so if he thereby transformed himself from an impressive, broadminded, well-informed accountant to a mere theorist.

Actually, therefore, if we get down to rock bottom, practically all accounting literature is practical literature, and what we refer to as theory is nothing more than a generalization to the effect that certain practices have been found useful in implementing basic accounting principles (complete disclosure or articulation of income with costs), or in doing all those other things which the accounting profession now generally recognizes should be done, or should not be done. This leads me to suggest that account-

ing theory with some exceptions is not theory in the sense that it is abstract knowledge or that it exists only in the mind. We accountants base our procedures almost wholly on practice, and we are expert in the sense that we interpret technical considerations to meet the exigencies of practice. There are exceptions of course. For instance, I read an article some months ago which argued that a proper disclosure of the financial position of American corporations should take into consideration the change in value of the monetary unit. Certain parts of the plant, it was pointed out, might have been acquired when the index value of the monetary unit was 100, the balance when the value of the monetary unit was 225. The sum of the two items was said to be misleading. Whether or not one agrees with this proposal, one is forced to agree that the writer is one of those peculiarly unusual animals—an accountant thinking abstractly? The vast majority of accounting literature is not concerned with such proposals, but rather reflects the composite experience of either an accountant or a group of accountants, and their adaptation to or reconciliation with accounting conventions.

Proposition 4 is not one which most accountants would consciously accept, but is one which unfortunately a great many of them do unconsciously use. We tend to resist a new proposal. Fortunately I don't think it is particularly characteristic of accountants that they resent the intellectual exercise necessary to grasp a wholly new and unique concept, but it is true that tired and lazy minds ordinarily tend to excuse their behavior on the grounds that the proposal is "theoretical and impractical".

Proposition 5 is probably a justifiable attempt on the part of the academician to stand up for his rights. After all the academician does play an extremely useful part in society; we need bystanders and philosophers in accountancy just as badly as they are needed in other professions. In an attempt to serve his under-privileged ego, the professor is inclined to advocate theory as the alpha and omega of professional practice. Sometimes he tends to go too far, but I can understand his motives and his frustrations.

I have already hinted that in my own humbly offered opinion the accountant tends to be a pragmatic thinker. That is to say the test of a principle is its general accept-

ability or workability. Conventions tend to become principles. The accountant is concerned in deciding what procedures are in the best interests of society as a whole, and how statements and reports and books should be maintained and presented so as to offer an effective workable medium of reporting and interpreting financial transactions. As such he may be, but is not ordinarily consciously concerned with abstract thought. To him theory and practice are exactly the same—they are identical concepts. Theory is nothing more than a generalized statement of that which, through experience, is found to be useful in actual practice.

> *"Really, now you ask me," said Alice, very much confused, "I don't think—"*
> *"Then you shouldn't talk," said the Hatter.*

This leads me to make a few comments on that type of thinking which is characteristic of the accountant. I suggest as a psychological premise that certain habits of thought, and methods of thought, characterize respective vocations. The interest tests recently devised for the American Institute of Accountants were seemingly based on this premise. Accountants as a group were found to "like" the same things, so were architects and ministers and mathematicians classified in groups as possessing group habits, or "liking" similar things. By implication, if an applicant "likes" the same things as existing successful accountants, he possesses an aptitude for the accounting profession. This is tantamount in my view to saying that accountants tend to have the same habits of thought, because we tend to do what we like to do and to reason as we like to reason. It is notable, for instance, that on the scoring chart the accountant is quite a long way from the lawyer and the musician. This is understandable—a lawyer is fundamentally a logician. He may choose his side, but in many instances his hypothesis is forced upon him. His attitude of mind suggests that there are at least two sides to a question, and his processes of thinking are therefore concerned in making his side sound as reasonable and compelling as possible. As an idealist he believes that the ends of justice are best served in so doing. To the musician or the literateur beauty of tone or expression tends to be

truth: he has thought processes different from the applied scientist or the lawyer.

The practising accountant is probably a scientific thinker. He approaches the search for truth with an hypothesis in his mind and, by inspection, analysis, or classification, he confirms or rejects his hypothesis somewhat in the same way as an entomologist uses his microscope. The particular skill to his thinking rests on his ability expertly to codify and clarify involved and complicated data, to dispose of irrelevant side issues, and then to decide whether the procedure originally proposed conforms to accepted accounting principles. This would seem to be a scientific mode of approach. I happened to have trained under a Scottish accountant (the late J. B. Sutherland F.C.A.) who was, in my opinion, an outstanding example of the scientific accountant. No matter how complicated a problem or how involved the facts, he would examine them in a microscopic way, remove the superfluous, and conclude with devastating clarity, "These are the basic facts, and the suggested approach is therefore contrary to this accounting principle, or adaptable to that accounting principle." I observe many such accountant scientists amongst my friends in the profession today.

Before I return from this voyage on the sea of psychology (on which I should probably never have embarked), I had better qualify these generalities. I do not suggest that no lawyers are scientists—quite the contrary. There is a scientific side to law, and I know lawyers who are very able scientific thinkers. Nor do I suggest that mathematicians and bio-chemists and accountants, all being scientists, tend to possess identical habits of thought. On the contrary, I incline to the view that the modern accountant sometimes tends to think more like a lawyer than like a mathematician. As Mr. Stikeman points out in his excellent article (May CHARTERED ACCOUNTANT), we may expect our profession to be influenced more and more by that method of thinking which so far has peculiarly characterized the lawyer. All accountants do not possess identical thought processes, all scientists are not identical in method. All scientists are, however, bound by a common desire to search for truth. Accountant scientists have particular attributes of their own; a pragmatic tendency, possibly, to

accept as truth that which is useful in confirming the best interests of the profession as a whole; a capacity to adapt oneself rapidly to changing conditions, common sense if you like; an aptitude to come to conclusions as quickly as possible; a tendency to take up the cudgels on behalf of the client. Then, too, our thinking is partly influenced by ethics. We possess principles of an ethical nature, devised to protect society as we observe the need, and we tend to rationalize or reconcile proposals in the light of such ethical standards. As Professor Lodge (University of Manitoba) has pointed out in his excellent book, "The Philosophy of Business", the thinking of the modern business man has been appreciably influenced by the idealistic school of philosophy.

> *"Tut, tut, Child,'" said the Duchess. "Everything's got a moral if only you can find it."*

That is why in choosing student applicants I would prefer the university graduate. He is, or should have been, trained to approach a problem as a scientist approaches it. If a scientific approach has been related to accounting data so much the better. That is why, too, I am somewhat concerned over the correspondence course method of training accountants. It should be recognized as a stop gap, but not a solution. It is true that the right type of literature tends to train minds to right methods of thinking, but it is true too that the effective training of a young scientist should include the observance of a trained scientist at work, and the emulation of his thought processes. Education for accountancy is essentially a method of training minds for accountancy, and not a process of injecting knowledge through a hypodermic needle. The correspondence course method of necessity greatly enhances the responsibility of a principal to his student. Possibly it would be better to require the principal to take the correspondence course instead of the student. But would that mean that the principal would be required to write the examination—?

All this sounds very remote and academic. When the text book told us that accounting is a science, and therefore it should be approached in a scientific way, we glossed over the paragraph with the thought that "that is just

one of the things text book writers like to say. It is not practical and useful. Let us get on to Chapter 7 which tells us how inventories should be verified." Actually, however, it *is* basic and it *is* useful. When we train accountant scientists we train thinking accountants, able to think in terms of the proper function of their profession in relation to the welfare of humanity as a whole and able to adapt themselves to the needs of a changing society. When we train accountants by memorized formulae we actually train bookkeepers.

Let us be even more academic. Accountancy is not only a science it has also its philosophical side. Every vocation, if it is a profession, must of necessity possess its philosophy, its capacity to generalize. When a doctor experiences a number of cases in which a peculiar condition would seem to be associated with a particular cause, he hastens to inform his fellow practitioners. In doing so he tends to make a general statement . . . "Under certain conditions this may generally be true, and corrective measures may generally be applied as follows." The lawyer applies a series of specific cases to state a general rule of law. The engineer applies specific experience to make a general statement useful to those who are trained to understand. This is a process of philosophy. Without it our vocation as a profession ceases to exist. I have already pointed out that with some exceptions accountants are not inclined towards speculative or abstract thinking, rather does the philosophy of accountancy rest on its endeavor to protect society by a development from particular experience to general principle.

Protect me from the suggestion that I deprecate what has been accomplished, or criticise what is being done in training accountants. "It may not be perfect," you say "but it works. We are turning out good men. Our profession stands high in public esteem." Right! But the higher we go the more precarious our stance. We are now training students by the thousands, rather than the hundreds. The direct influence of principal on student is becoming endangered. More and more is expected of us, as our profession matures. Complacency in training methods is misleading and dangerous.

Some of this is written with my tongue in my cheek.

Some is merely provocative. Some is conviction. This I write in deadly seriousness. The future of accountancy rests on the capacity of the profession to attract potential students with an aptitude and capacity to think in a scientific way, then to train such minds to think as accountant scientists. This purpose is not served by sparring with shadows, by making weird distinctions between accounting theory and practice. That is a fetish which it would be well to abandon.

> *"Reeling and writhings, of course, to begin with," the Mock Turtle replied, "and the different branches of Arithmetic—Ambition, Distraction, Uglification and Derision."*

LIFE COMPANY FINDS TALL MEN HAVE MORE INSURANCE

Not long ago, says the July "Bulletin" of the Confederation Life Association, an American life insurance company, in making an analysis of 269,600 policies that it had issued to white males over a period of seventeen years, discovered the unexplainable fact that there is a direct relation between the amount of insurance per policy and the height of the insured. With each additional inch in their height, the average face value of their policies increased proportionately—from $2,979 for men of just five feet to $5,906 for men of six feet five inches. (Canadian Finance, September 17, 1947.)

Editor's Note: It seems to us that the answer is readily found; it all depends on whether one takes a short or a long-range point of view! We always did wonder a little bit about these statisticians.

TAX DEPARTMENT

LEGAL DECISIONS RESPECTING THE INCOME WAR TAX ACT OF CANADA

INCORRECT ASSESSMENT
ONUS OF PROOF ON APPELLANT

Roderick W. S. Johnston, Appellant
—and—
The Minister of National Revenue, Respondent
(The Exchequer Court of Canada, O'Connor, J., 23rd August 1947).

The appellant is a married man whose wife, during the year 1944 had a separate income other than earned income of $660.00 in the taxation year. The appellant also had three children under 18 years of age dependent on him. He filed his income tax return on the basis that he supported his wife. An assessment was made on the basis that he did not support his wife.

Instead of calling evidence, counsel for the appellant and counsel for the respondent agreed that no evidence would be given but agreed to the following facts set out in an admission of facts:

1. The appellant and his spouse occupied the same dwelling.
2. The appellant's income exceeds the income of his spouse.
3. The appellant and his spouse both contributed to the maintenance of a common household in such dwelling, the operation of which was managed by the appellant's spouse.
4. The whole income of the appellant's spouse was expended for her personal expenses and as a contribution to the expenses of such common household.

HELD:

"These facts agreed upon do not, in my opinion, establish that the applicant supported his wife or that he did not do so. No finding of fact can be made so that the case cannot be dealt with on the merits. It is merely a question of whether the onus is on the appellant or on the respondent. Whether the taxpayer has been assessed on a correct basis or on an incorrect basis, the assessment is valid and binding unless an appeal is taken and the Court determine that the assessement has been made on an incorrect basis.

"On the appeal then the onus is on the appellant to establish from the "facts, statutory provisions and reasons which he intends to submit to the Court in support of the appeal" in the language of Section 60(2) of the Act, that the assessment is incorrect. If such facts or statutory provisions and reasons are not submitted to the Court, the assessment cannot be found to be incorrect.

"The appellant has failed to show that the assessment was incorrect, either in fact or in law, and the appeal must be dismissed with costs."

INCOME—DETERMINATION BY THE MINISTER

Harry Dezura, Appellant
—and—
The Minister of National Revenue, Respondent
(The Exchequer Court of Canada, Thorson, P., 17th November 1947)

The appellant, who operated a country hotel with a dining room

and beer parlour, reported a net taxable income of $135.75 for 1940 and $338.43 for 1941. While the appellant had kept records of receipts and expenses for the years in question in a school exercise book and had used these accounts in preparing his returns, they had been lost and were not available for inspection by the Income Tax Department officials. Acting under the authority of section 47, the Minister determined the beer parlour sales for 1940 and 1941 as being $11,044.80 and $10,984.10 instead of $8,710.04 and $10,526.50 as returned by the appellant, and the net taxable income as being $2,565.31 and $1,025.98 respectively. The sales figures had been determined by using information obtained from the Liquor Board of the Province and estimating the sales receipts of draught beer at $32 per keg.

HELD:

"The statement in section 47 that the Minister may determine the amount of the tax to be paid by any person is only another way of saying that he may determine the amount of any person's assessment, for when the amount of the assessment is determined the amount of the tax to be paid follows as a matter of course. It ought really to be included in the part of the Act dealing with assessment rather than in that relating to returns. When read with its context it means that the Minister is empowered to determine the amount of any assessment without being bound by any return or information and even although no return has been made. . . . . The effect of the section is that when the Minister makes an assessment under the section there is a presumption of validity in its favor which is not rebuttable by proof that its amount is different from that shown on the taxpayer's return or information supplied by or for him or that no return has been made.

"It was contended on behalf of the respondent that the Minister's determination was the exercise of an administrative discretionary power and as such not reviewable by the Court. I have come to the conclusion that this contention is quite untenable. In my opinion, the Minister's power under section 47 is not of the same kind as the various discretionary powers vested in the Minister by the Act such as, for example, that conferred by section 6(2), whereby he is made the sole judge of the particular matter entrusted to his discretion so that when he has acted in the manner required by law in the exercise of his discretionary power his actual exercise of it is not subject to review by the Court. There is a difference between the exercise of discretionary powers in respect of particular items that may enter into an assessment and the assessment itself, as explained in *Pure Spring Company Limited* v. *Minister of National Revenue* ((1946) Ex. C.R. 471, at 498). Such discretionary powers must be exercised before the assessment operation, which is purely an administrative function of the Minister not involving the exercise of discretion, can be performed at all. But the power under section 47 is not concerned with any particular item. It is general in nature and relates to the amount of the assessment as a whole. In my view, a right of appeal from such amount is expressly given by section 58 of the Act . . . .

"While the Minister's power under section 47 is not expressly limited it is not unlimited in the sense that he may do as he pleases. It is quite clear, I think, that the power must be exercised within the Act and subject to it. That opinion was expressed in *Trapp* v. *Minister of National Revenue* ((1946) Ex. C.R. 245 at 255) where it was held that when the Act has fixed a particular basis of taxability of income section 47 does not empower the Minister to depart from

such basis and fix a different one. Parliament could not have intended to confer any extraordinary or over-riding general power upon the Minister. All that he is empowered to do is to find the fact of the amount of the assessment in the case of any person regardless of the amount shown by his return or information supplied by or for him and regardless of whether he has made a return or not.

"While I was favourably impressed with the manner in which Mr. McFadyen gave his evidence I have come to the conclusion that the estimate of gross receipts of $32.00 per keg was too high . . . It is clear that it was intended that the estimate should not be too low but should amply protect the revenue and this is to be expected.

"While I am satisfied that the estimate of $32.00 per keg is too high, it is difficult in the absence of reliable records to find precisely how much too high it is. But since the Minister's estimate is reviewable the Court may substitute its finding even although such finding may itself have to be an estimate. On the evidence as a whole, I am of the opinion that a gross return of $28.00 per keg was more likely in the appellant's case than the amount estimated by the Minister, and I so find. This would mean approximately 7 ounces of beer per glass rather than 6¼. While I do not think the appellant is entitled to full credence in view of his initial erroneous returns I am of the opinion that he has sufficiently satisfied the onus of showing that the amounts of the assessments under appeal were incorrect and that a reduction of $4.00 per keg ought to be made. The assessment for 1940 should, therefore, be reduced by $832.00 and that for 1941 by $670.00. To the extent of such reductions the appeals will be allowed. The appellant is entitled to costs to be taxed in the usual way."

EXPENSES DISALLOWED

Imperial Oil Limited, Appellant

—and—

The Minister of National Revenue, Respondent

(The Exchequer Court of Canada, Thorson, P., 31st October 1947)

In 1927 a motorship owned and operated by the company and used in transporting petroleum and petroleum products, collided with a vessel owned by a steel company. The appellant's liability was finally determined in 1930 as $527,000, which amount was charged to the profit and loss account of that year. This amount was disallowed when the return was assessed.

HELD:

"The issue turns upon whether the amount sought to be deducted is excluded from deduction by section 6(a) .....

"It (the section) is a specific instruction to the Minister that in his assessment operation he is not to allow the deduction of disbursements or expenses that are "not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income". The section directs that such disbursements or expenses are not to be deducted, even although they might be deductible according to ordinary principles of commercial trading or, as it has been suggested "well accepted principles of business and accounting practice". The range of deductibility according to such principles may be wider than that which is inferentially permitted under the section . . . . The result is that the deductibility of disbursements or expenses is to be determined according to the ordinary principles of commercial trading or well accepted principles of business and accounting practice unless their deduction is prohibited by reason of their coming within the

express terms of the excluding provisions of the section . . . The section ought not, in my opinion, to be read with a view to trying to bring a particular disbursement or expense within the scope of its excluding provisions. If it is not within the express terms of the exclusion its deduction ought to be allowed if such deduction would otherwise be in accordance with the ordinary principles of commercial trading or well accepted principles of business and accounting practice.

If the present case were being determined under the law in force in any of the jurisdictions referred to I have no doubt that the deduction sought by the appellant would be allowed. The issue of fact is whether the payment made was in respect of a liability for a happening that was really incidental to the business. In my view, there is no doubt that it was. The undisputed evidence is that the transportation of petroleum and petroleum products by sea was part of the marine operations of the appellant and part of the business from which it earned its income, that the risk of collision between vessels is a normal and ordinary hazard of marine operations generally, and that, while the amount of the appellant's liability in the present case was unusually large, there was nothing abnormal or unusual about the nature of the collision itself. Negligence on the part of the appellant's servants in the operation of its vessels, with it consequential liability to pay damages for a collision resulting therefrom, was a normal and ordinary risk of the marine operations part of the appellant's business and really incidental to it.

That being so, the question is whether the law under section 6(a) of the Income War Tax Act is so fundamentally different from that of the other jurisdictions referred to as to exclude deductibility of the amount claimed. I have come to the conclusion that it is not.

It is obvious that the words "for the purpose of earning the income" in section 6(a), as applied to disbursements or expenses, cannot be construed literally, for the laying out or expending of a disbursement or expense cannot by itself ever accomplish the purpose of earning the income. As Watermeyer A.J.P. pointed out in *Port Elizabeth Electric Tramway Company* v. *Commissioner for Inland Revenue* (supra), income is earned not by the making of expenditures but by various operations and transactions in which the taxpayer has been engaged or the services he has rendered, in the course of which expenditures may have been made. These are the disbursements or expenses referred to in section 6(a), namely, those that are laid out or expended as part of the operations, transactions or services by which the taxpayer earned the income. They are properly, therefore, described as disbursements or expenses laid out or expended as part of the process of earning the income. This means that the deductibility of a particular item of expenditure is not to be determined by isolating it. It must be looked at in the light of its connection with the operation, transaction or service in respect of which it was made so that it may be decided whether it was made not only in the course of earning the income but as part of the process of doing so.

Where income is earned from certain operations, as it was by the appellant from its marine operations, all the expenses wholly, exclusively and necessarily incidental to such operations must be deducted as the total cost thereof in order that the amount of the profits or gains from such operations that are to be assessed may be computed. Such cost includes not only all the ordinary operations costs but also all moneys paid in discharge of the liabilities normally incurred in the operations. When the nature of the operations is

such that the risk of negligence on the part of the taxpayer's servants in the course of their duties or employment is really incidental to such operations, as was the fact in the present case, with its consequential liability to pay damages and costs, then the amount of such damages and costs is properly included as one of the items of the total cost of such operations. It may, therefore, properly be described as a disbursement or expense that is wholly, exclusively and necessarily laid out as part of the process of earning the income from such operations. It cannot be said, under the circumstances, that the payment of such damages and costs is made out of profits. It is no such thing. Being an item of the total cost of the operations it must be deducted, along with the other items of cost, before the amount of the profits from the operations can be ascertained.

For the reasons given I have no hesitation in finding that the amount sought to be deducted by the appellant would properly be deductible according to the ordinary principles of commercial trading and well established principles of business and accounting practice as an item in the total cost of its marine operations, and that it falls outside the excluding provisions of section 6(a). The amount was, therefore, improperly added to the assessment and it should be amended accordingly. The appeal must, therefore, be allowed with costs.

INCORRECT ASSESSMENT
ONUS OF PROOF ON APPELLANT

Charles H. A. Armstrong, Appellant
The Minister of National Revenue, Respondent
(The Exchequer Court of Canada, O'Connor, J.,
23rd August 1947).

The questions involved were the same as those in the case of Roderick W. S. Johnston and the two appeals were heard together.

The reasons for judgment in the Johnston case were incorporated mutatis mutandis in this one and the appeal was dismissed with costs.

The Income Tax Revision

by The Canadian Tax Foundation*

Judged by its contents, the Income Tax Bill has three main objects:

1. to restate the existing law more clearly;
2. to curtail the Minister's discretionary powers;
3. to make certain changes in the law where they are necessary to improve its operation.

In the Bill's present form treatment of the third point is subordinate to the first two. Further changes, however, may be introduced before the second reading.

The intention is to make the existing machine work more smoothly. Its basic structure remains unchanged. Broader questions of policy therefore have not been introduced at this stage, although no limitations have been suggested regarding views which the public has been invited to express.

The Bill incorporates the current tax rates and exemption limits which will no doubt be reviewed independently when the next Budget appears.

LAW AND REVENUE

This distinction between improving the law and altering the tax is a new departure in Canada which deserves emphasis. Hitherto, these objects have been treated together in the annual budget proposals. The former has suffered conspicuously in consequence. Amendments seriously affecting the revenue must doubtless be so treated. But intended improvements in the law call for separate consideration in view of the difficult problems encountered and the non-partisan treatment which they require.

The present Bill is only a start in this direction; and if the new approach is justified by its results it may be hoped that it will become established practice.

The three aspects of revision stated above correspond substantially with the main grounds of dissatisfaction with the present Act. A verdict that they have been accomplished successfully would indicate that the Bill has achieved its immediate purpose,—the further purpose being to provide a sound basis for future changes as required. It is therefore suitable to divide discussion under these three headings. If attention can be focussed upon them, the present objectives will be accounted for and the way will be left clear for subsequent treatment of more technical problems and broader questions of policy.

I. REARRANGEMENT AND CLARIFICATION

Re-statement of the existing law has several phases. The first is the consolidation of the amendments of the past twenty years with the Act of 1927, when this was last done. The need is shown by the way in which the income tax law has grown. When it originated in Canada in 1917, the Act consisted of 24 Sections, covering 10 pages. When it was consolidated with its amendments ten years later it ran

*See CANADIAN CHARTERED ACCOUNTANT, March, 1947, for an announcement of the constitution and purposes of the Canadian Tax Foundation. This article has been published by the Canadian Tax Foundation in brochure form, with certain introductory and appendix material here omitted. Copies of the brochure are obtainable free of charge from Canadian Tax Foundation, 83 St. Joseph Street, Toronto 5.

to 82 Sections. Since then, there has been a succession of new Acts "to amend the Act," twenty-six in all, amounting to nearly 250 pages. The results from year to year have been reduced to more manageable form by "Office Consolidations," but these have never been adopted by Parliament. The law in its statutory form consists today of the 1927 Act and its twenty-six dependent statutes.

CONSOLIDATION LONG OVERDUE

This process has tended to cumulative confusion. The twenty year old framework has been overgrown by the amendment, repeal, substitution and addition of many sections which have become subject to the same process in their turn. These include many complications of doubtful value designed to stop minor leaks. Added to this, the fact that these alterations have usually been made in the course of budget debates towards the end of parliamentary sessions has often prevented careful scrutiny and draughtsmanship. Reconstitution of the statute is therefore long overdue regardless of other improvements to be made at the same time.

Consolidation opens the way for simplification both by rearranging the law in order to make it more accessible, and by reducing some of its complexity. At present, it is often difficult to know with certainty what sections of the Act are relevant to a given question. The new arrangement of the Bill, which the table of contents shows at a glance, is visibly more coherent.

CLARIFICATION IS DIFFICULT

The most difficult phase of clarification, however, concerns the inherent complexity of all income tax law. Attempts to improve this state of affairs soon encounter the dilemma that if you aim at certainty, equity and simplicity you cannot gain one without sacrificing the other two. The British Royal Commission on the Income Tax in 1920 stated its conclusions on this point in terms which apply generally, as follows:

> "A plea for simplicity was made by a great number of witnesses, some of them experts in dealing with Income Tax matters on behalf of the public, but we found their suggestions generally vague and indefinite. They were either unable to give us concrete or definite proposals, or where they did make proposals, we found that to adopt them would be to do injustice to taxpayers whose peculiar circumstances would not have been recognized, or to expose the Revenue unnecessarily to the risk of loss. We have formed the opinion that in Income Tax matters simplicity is not the sole object to be aimed at, and that the price that would have to be paid for a simple Income Tax could not be justified.
>
> "On the other hand, a tax that aimed at providing legislative provisions for every case, so that no hardship of any sort should be possible, would be so intricate and detailed, so full of exceptions and provisos, that it would be unintelligible to the ordinary taxpayer, and would render the machine ineffective. Mr. Gladstone's declaration in 1853—'Whatever you do in regard to the Income Tax you must be bold, you must be intelligible, you must be decisive'—has lost little of its force in the intervening years, though the advice it contains is now much more difficult to follow. There is a point at which legislative provision must cease if the tax is not to be smothered under a mass of detail."

The object of making the law easier to understand and apply runs all through the Bill, and the obstacles should be kept in mind if the results are to be judged fairly. The Bill employs new language freely.

The essential test is its precision, both for the taxpayer and for the administration. This will have to be checked in detail throughout, particularly by persons who are familiar with the existing jurisprudence, because even minor changes of wording may alter the law unexpectedly, leaving the taxpayer and the Department without guidance until new interpretations are established. Here it is possible only to call attention to one or two main groups of provisions which have been extensively rewritten and which are intrinsically important by reason of their application and their position in the statute.

COMPUTATION OF INCOME

The first is Division II, headed "Computation of Income". It contains twenty-two sections which, as the caption indicates, are fundamental to the purpose of the statute. Some of these involve deliberate changes of the law which will receive special notice under the third heading below.

The Division as a whole adopts a new approach which may be indicated briefly. In contrast with the present Section 3 of the Act, which carries the misleading caption "Taxable Income Defined" and proceeds by listing examples and special cases over the space of five pages, Division II starts with a new Section 3 reading simply as follows:

> "The income of a taxpayer for a taxation year for the purposes of this Part is his income for the year from all sources inside or outside Canada and, without restricting the generality of the foregoing, includes income for the year from
>
> (a) businesses,
>
> (b) property, and
>
> (c) offices or employments."

Then follow general rules regarding these three classes of income, leading in turn to the methods and basis of computation.

The Act never really defined income, and the Bill does not now pretend to do so. The law relies on the presumption that income can be recognized as such in ordinary experience, and makes this presumption work by stating more or less adequately what is to be included or deducted. It is in these rules, therefore, that the operative provisions respecting the actual basis of the tax are to be found.

The test that they should be found intelligible, administratively straight-forward and reasonably consistent with existing decisions of the courts applies with particular force to Sections 4 to 24, inclusive, of the Bill. It is not desirable to review every instance here and it is difficult to select special cases out of many, but Section 9, which covers reorganization of corporations, undistributed profits and related matters, may be mentioned as a particular example for comparison with Sections 13 to 20 of the Act. Other cases in Division II where further clarification appears to be required will be found on reference to the text of the Bill, and they should of course be taken in their full context.

TAXABLE INCOME

"Income" being thus established, the Bill proceeds in Division III to reduce the result to "Taxable Income" as a separate concept.

In order to treat the three classes of income enumerated in Section 3 on a common footing for all taxpayers, individual or corporate, the Bill deliberately avoids use of the expression "net income." It is, however, the function of Division II to determine net income for tax purposes so far as business and property incomes are concerned. Division III is therefore largely occupied with individual deductions, and

as regards business income, covers only losses, dividends received by corporations, research expenses, allowance for taxes paid on mining or logging profits, and taxable income of life insurance companies. The simplified provisions respecting business losses in Section 26(d) should be read in conjunction with the new definition given in Section 109(1)(p).

FURTHER EXAMPLES

Divisions II and III are the main functional parts of the Bill. Other parts which may be mentioned as deserving special attention from the standpoint of clarification are Division IV and Part II, both respecting Non-Residents, the former admitting more liberal methods of determining taxable income, and the latter, in Section 74(1)(g), extending the scope of the 15% tax on income derived from Canada. The provisions governing Consolidated Returns, which appear in a new version in Section 73, are also of interest by reason of more extended treatment. The additional 2% rate of tax, reflecting assumptions which can hardly be justified any longer, is incidentally retained.

The foregoing references are not exhaustive. They simply point to some of the more striking examples of new arrangement or expression. In addition, two other parts of the Bill will require special scrutiny from the standpoint of changing over, namely, Part VII, "Interpretation," which contains a large number of new definitions, but may prove to be incomplete; and Part VIII, "Transitional Provisions," which provides the statutory link between the old legislation and the new.

II. MINISTERIAL DISCRETION AND APPEAL PROCEDURE

This heading covers the most important changes introduced by the Bill, which must be considered against the existing background.

The necessary flexibility in the application of the law to cases which cannot well be brought within the scope of statutory definition has been provided hitherto by grant of authority to the Minister of National Revenue to decide such questions in his discretion. This authority is delegated in practice to the Deputy Minister, whose decisions are final.

The taxpayer's right of appeal to the Exchequer Court has afforded no recourse because it has been a well-established rule of law that the Court may not question the Minister's opinion. It would only determine whether his discretion had been exercised properly, that is to say, in accordance with the established legal rules. The merits of the Minister's opinion had nothing to do with the case and the Court did not substitute its own. If it found that discretion had been improperly exercised the Court might refer the case back again to the Minister. Otherwise his action was confirmed. No other outcome was possible. (How far this situation may have been changed by the recent Privy Council decision in the Wright's Canadian Ropes [1947] 1 D.L.R. 721, also CANADIAN CHARTERED ACCOUNTANT, February, 1947, case is still a matter of opinion.)

The appearances of discretionary power in the law have become so frequent that the number varies according to the method of reckoning them. It was stated to the Special Committee of the Senate last year that they occurred in 95 sections or subsections of the Act. Many are simply concerned with administrative functions, which are not in question. But a larger number make the Minister the final judge of equity or of facts, and thus confer a quasi-judicial or quasi-legislative responsibility.

MUTUAL DISADVANTAGE

This situation has undesirable consequences for all concerned. For the taxpayer the position is inequitable in principle because it is uncertain in practice. Perhaps the gravest practical objection is delay and difficulty in determining actual or prospective tax liability in cases which depend upon the Minister's decision.

For the administration, the scope of the powers involved and the absence of judicial guidance have prevented the development of uniform and tested principles which the extent of the Minister's responsibility requires to support it, and which the taxpayer is entitled to know.

For the law itself, the same factors lead into the dark; and lacking the opinion of the Courts upon any of the matters thus removed from their jurisdiction, Parliament has not been in a position to review and restate the law in the light of experience.

Dissatisfaction on these grounds, particularly during and since the War, has led to a general demand that the exercise of discretionary power be curtailed and be made subject to judicial review by an independent body having power to substitute its own opinion for that of the Minister.

In addition, the increased severity of taxation has created a need for a court easily accessible to the average taxpayer without undue expense or delay. This is not a new idea. The Act of 1917 originally provided for a Board of Referees to act as a court of revision, but nothing was done and the provision was dropped by amendment in 1923 when the present system of appeals was introduced.

REMEDY PROPOSED LAST YEAR

The Government responded to these demands when the Act was amended last year to provide for an Income Tax Appeal Board constituted as a court of first instance, and for an Income Tax Advisory Board intended to guide the Minister in the exercise of his discretionary powers, which themselves remained unchanged.

The Appeal Board would have had no power to review the Minister's discretionary decisions, while the Advisory Board would have had power only to advise the Minister to vary his decisions, which would continue to rest with him.

This solution avoided interference with the principle of the Minister's direct responsibility to Parliament for the authority which the Act required him to exercise, and maintained the existing scope of his discretion. It was therefore a compromise.

JUDICIAL REVIEW PROVIDED

This plan remained in abeyance as broader revision of the Act was undertaken. The new Bill goes much further. Retaining last year's provisions for the Appeal Board, the Bill brings within its jurisdiction and removes from the Minister's discretion a long list of matters which the law would leave in such a way as to make them dependent on questions of fact. This involves the general substitution of such expressions as "reasonable in the circumstances," for the typical discretionary formula "determined by the Minister".

Reference to such indeterminate standards does not change the taxpayer's position so far as presenting the facts of his case are concerned. The Minister has always been obliged as a practical matter to use reasonable judgment, and there is evidence that the taxpayer often received the benefit of the doubt. But the new method puts the opinions of the taxpayer and the Department on the same footing and requires a judicial decision in case of dispute.

The principle of the Minister's responsibility is respected by restricting his discretion to matters of a generally non-contentious character.

DISCRETIONARY POWERS CONVERTED

The proposed sweeping treatment of discretionary powers leaves the administrative class generally unaffected. Remaining as within this group is the Minister's right to disregard information supplied by the taxpayer in determining his assessment (Section 42(5)).

As to the rest, a few are dropped entirely, and the remainder are converted to a rule of law dependent upon a question of fact as explained by the Minister of Finance in introducing the Bill. Of the latter, there are three cases in which the law remains to be spelled out more fully by Orders-in-Council, namely: the income value of property maintained under a trust (Section 8(3)); residential status and amounts taxable for the purpose of the withholding tax on persons resident both in Canada and abroad (Section 78); and the most important question of deductions to be allowed respecting "capital cost of property" (Section 11(1) (a)), to which further reference is made below. There is also one case where a question previously left to the Minister's discretion is now to be defined in the Statute itself. Section 19 would require interest deemed to be received by a Canadian company on a loan to a Company abroad to be computed at 5%.

SECTION 32A

Related to the matter of discretion is the special authority given to the Treasury Board by the present Section 32A of the Act. This empowers the Board to direct adjustment for purposes of assessment of any transactions which it has decided have been undertaken for the main purpose of "avoidance or reduction" of tax liability. This provision is retained in Section 108 of the Bill.

When this emergency power was introduced during the War it was acknowledged that it should have no permanent place in the statute. The extremely broad and ambiguous terms in which this authority is expressed make it potentially applicable to legitimate transactions in which the taxpayer needs to know his prospective tax liability but is unable, in consequence, to determine it with certainty. Whether or not its retention can now be justified, it also appears anomalous in the context of the new appeal procedure, because it is provided that appeals from such decisions lie directly to the Exchequer Court, and this would mean that the Appeal Board is to have no jurisdiction in regard to them.

RESPONSIBILITIES OF APPEAL BOARD

It is clear that the success of the new arrangements will depend largely upon the Appeal Board. Its responsibility will not be confined to ad hoc settlement of tax disputes, but will extend to the development of a consistent code of interpretations which will provide in course of time a body of subsidiary jurisprudence for the guidance of taxpayers and of the Department.

However competently these functions may be discharged, there is some danger that the great variety of matters on which interpretation is required, together with the volume of cases appealed, will lead to the adoption of rule of thumb standards in order to dispose of them.

Even if this danger is avoided in the Board itself, it will remain at the departmental level where the new position may be conducive to rigid and mechanical application of provisions which are intended to operate flexibly. If this should happen the result would be tanta-

mount to abolition of the whole principle of administrative discretion.

Experience will answer these questions. Perhaps it may prove necessary in the result to seek an alternative solution for the problem along other lines which have been widely advocated. This might involve restoring the Minister's discretionary powers in matters which cannot be defined by statute, but making them subject to review by the Appeal Board, which would then have to be empowered to substitute its own decisions. To the objection that this arrangement would compromise the Minister's responsibility, it may be replied that ultimate decision of the law's requirements by the courts is a principle of no less weight, and that Parliament will always have the remedy of changing the statute if judicial interpretation should tend to conflict with administrative policy.

One conclusion is clear beyond doubt. It is of utmost importance that the Appeal Board be composed of men who are qualified to decide the cases coming before them without delay, whose decisions will be respected by both sides, and who will be capable of developing the code of rulings which the new form of the law will require for its successful operation.

III. CHANGES OF SUBSTANCE IN THE LAW

The third feature of the new legislation, which remains to be considered here, concerns new provisions to be introduced and old provisions discarded. While such changes have naturally attracted particular attention, they are probably the least conclusive aspect of the Bill as it now appears. When it comes up for second reading they may be considerably modified or extended. Apart from deliberate amendment of the law in this way, it has already been pointed out that some changes of effect are almost bound to follow from rearranging and re-writing it for the purpose of clarification. In reviewing the Bill as a whole it is practically impossible to draw a clear line between the two types of cases.

OMISSIONS AND ADDITIONS

So far as the most obvious changes are concerned, the Bill omits twenty-three sections of the Act, in addition to certain definitions and last year's provisions concerning the Income Tax Advisory Board; and it introduces twenty-one sections marked as new, as well as many fresh definitions in Part VII, and the transitional provisions contained in Part VIII. Collectively the effect of these alterations amounts to less than the various amendments adopted since the end of the War.

Some of them, however, introduce new methods in particular matters which deserve mention.

Most of the sections which have been dropped were obsolete or had become unnecessary owing to changes in other respects. But a few omissions alter the actual law. Examples of the latter, citing the Act, are Sections 5(5) and 6(1)(m), affecting non-residents; Section 15 concerning dividends deemed to be paid when undistributed income was capitalized (but see Section 9 of the Bill which may be changed further to compensate); and Section 19(2) insofar as it concerns dividends deemed to be received by a Canadian company on the winding up or reorganization of another, which would now be exempted under Section 27 of the Bill.

It should also be pointed out here that Section 5(1) of the Bill, respecting individual income from office or employment, is so expressed as to exclude "any deduction whatsoever" except pension fund contributions, gifts to His Majesty, and alimony payments. This would

disqualify certain forms of expense which the existing law, although it is not clear on this point, has been held to allow.

IMPORTANT INNOVATIONS

Regarding the new sections, it should first be noted that deliberate changes of the law are not confined to those which are distinguished as new in the Bill. Marked departures are to be found in some of the revised sections which carry cross-references to the Act. The five examples which follow are taken from both classes, and all of them arise under the general heading of "Computation of Income" in Division II already referred to. The citations refer to sections of the Bill.

(1) *"Generally Accepted Accounting Principles". Section 4.*

The entire section reads as follows:

> "Subject to the other provisions of this Part income for a taxation year from a business or property shall be determined in accordance with generally accepted accounting principles".

The problem of providing a general rule for determining business profits which this formula is designed to meet is one of the most difficult in income tax legislation, and it is instructive to compare treatment by the Income Tax Codification Committee in the United Kingdom in 1936. Referring to a long line of cases arising out of the ambiguity of the British Act in this respect, the Committee stated its conclusions as follows:

> "We considered in detail these and other judicial pronouncements, and we decided that, in dealing with the computation of profits from businesses, our draft Bill should first contain a statement that the computation is to be made on ordinary commercial principles, and should then set out a list of specific matters allowed or disallowed in computing profits for income tax purposes, introduced by words making it clear that, if there is in any case a conflict between ordinary commercial principles and the provisions of the Bill, the latter are to prevail".

The Committee therefore proposed that the general rule be stated as follows:

> "The amount of the profits of a business for any accounting period shall be computed in accordance with *the ordinary commercial principles applicable to the computation of profits of that business.*"

The new formula would liberalize the law at a point where it has long been necessary to do so, admitting the regular accrual method of determining business income, and opening the way for proper treatment for tax purposes of such matters as bond discount, which has to be written off against profits over the term of the bonds. But the question will arise whether the treatment prescribed for the specific matters which follow in Sections 6 to 20 is sufficiently consistent with the formula itself. If it is not, the latter may become distorted under pressure of the law and lose much of its usefulness. More broadly, it is necessary to consider whether the expression "generally accepted accounting principles" will stand up to precise interpretation, and will afford a clear guide to the courts. The general intention is obviously sound, but the results will depend upon the legal interpretation of the terms employed which may open up a wide field of argument.

(2) *"Bad and Doubtful Debts". Section 6(1) (e) and (f) and Section 11(1) (d) and (e).*

Taken together these subsections affirmatively allow deductions for

bad and doubtful debts, and lay down the method of annual review to be adopted in computing income. Previously, the Act's failure to recognize the accrual method of accounting prevented appropriate statutory provisions in this respect. This is an innovation deserving the attention of business men generally. It should be read in conjunction with the transitional provisions contained in Section 111(7) of the Bill.

(3) *"Capital Cost of Property". Section 11(1) (a).*

This subsection, and the one immediately following which relates to the special case of oil or gas wells, substitutes a broader concept in place of "depreciation" and "depletion", which are not now mentioned as such under allowable deductions. Its scope and application remain to be developed by Order-in-Council, in the absence of which the clause by itself appears to give the taxpayer nothing. Its importance is indicated by quoting it in full:

> "11(1) Notwithstanding any other provision in this Division, the following amounts may be deducted in computing the income of a taxpayer for a taxation year
> (a) such part of the capital cost to the taxpayer of property or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation."

This provision offers a good illustration of the point already mentioned that the law, with the regulations issued thereunder, should itself conform to sound accounting principles if Section 4 of the Bill is to provide a satisfactory standard of reference. The amount charged to income respecting capital cost of property is a factor in ascertaining profit which cannot be treated arbitrarily without distorting the result and to that extent defeating its purpose.

(4) *"Limitation of Deductible Expenses". Section 12(1) (a).*

Here a new formula releases the taxpayer from the present unrealistic limitations of Section 6(1) (a) of the Act, regarding "expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income", which has produced much litigation. It now reads as follows:

> "12(1) In computing income no deduction shall be made in respect of
> (a) an outlay or expense to the extent that it was not made or incurred in gaining or producing income from property or a business".

While the freedom of this definition may be welcomed by taxpayers it may prove troublesome to the Courts, who are likely to encounter the problem of determining what expenses the law actually means to allow as often as before. It is interesting once again to compare the British Codification Committee's treatment of the corresponding question in their draft Bill, which reads as follows:

> "No deduction shall be permitted in respect of any item of expenditure or of charge except so far as it is attributable to and incurred for the purposes of business".

This is perhaps the leading example in the whole statute of the recurrent difficulty of expressing a sound and agreed principle in terms that can be relied on to work clearly and fairly.

(5) *"Inventories". Section 14.*

The particular interest of this new section lies in the fact that the permitted methods of valuing inventory, other than "at cost to the taxpayer or fair market value, whichever is lower", which is expressed in the Bill, remain to be defined by Order-in-Council. The present rise

of commodity prices attaches immediate importance to alternative methods. It would be useful if the considerations which should govern the regulations were thoroughly explored and discussed before they are due to appear, having regard to problems of different types of business. Different methods are appropriate to different cases, and it is undesirable that a taxpayer should have to use one method in order to show the true position of his business, and another to determine his taxes. The so-called "last-in first-out" method, which was recognized by the U.S. Internal Revenue several years ago, is a case in point.

Many other innovations will be found in the Bill by those who may examine it from the standpoint of their particular interests. The five listed above concern matters of general importance from the standpoint of normal business practice and illustrate the use of new methods to meet persistent problems. They deserve wide consideration before the Bill becomes law, especially where the efficiency of the statute itself depends upon them. It should be remembered that all these provisions are still in the fluid state and carry in their present form an invitation to taxpayers themselves to suggest better methods if they can.

. . . . . .

Anticipating the Bill in his Budget Speech this year, the Minister of Finance said, "We do not consider that this measure, when enacted as law, will constitute the final word, but we believe it will provide a framework within which further improvements can be made over the course of future years." The foregoing discussion has accepted this view.

Provided the search for improvements is continued in the manner begun, it appears that the essential thing now is to ensure that the framework itself will be fit to carry them, and while recognizing the need for something better, to achieve at least a statement of the existing law that reflects the lessons of past experience. This will prepare the way for constructive consideration in future of many matters which the Bill does not touch, and which it may be impossible to dispose of now.

Current Accounting Literature

by F. S. Capon, C.A.

Costing

Two articles on special phases of cost accounting are included in the 1st October N.A.C.A. Bulletin. J. D. Duskin of Columbus Manufacturing Company outlines methods of labour cost determination and control in a cotton textile mill. The pros and cons of actual and standard costs are covered and the labour cost problem is then analyzed in detail, with supporting schedules and tabulations.

Cost problems in the aluminum industry are dealt with by L. A. Doyle of Permanente Metals Corporation and, in particular, the special problems of that industry on the U.S. West Coast. The process starts with the mining of bauxite, from which alumina is produced. The powdered alumina is then converted into metallic aluminum at the reduction plant. Some special problems mentioned are those dealing with location and geographic costs of major materials, the geographic demand for the product, and others. Cost accounting for by-products, scrap, and costs by production centres are also reviewed.

Depreciation on Replacement Values

This problem, which has been killed and buried by accountants more regularly and frequently than any other, is now rearing its head higher than ever before. The October issue of the *'Journal of Accountancy'* contains three separate items dealing with the subject—an editorial, a statement by the Committee on accounting procedure, and a summary of the Committee's discussion with references to recent published financial statements in which

---

PUBLICATION ADDRESSES, AND PRICE PER COPY POSTPAID

Accountancy, Incorporated Accountants' Hall, Victoria Embankment, London, W.C. 2, England. 1 shilling.
Accountants' Magazine, 23 Rutland Square, Edinburgh, Scotland. 1s. 3d.
Accounting Review, School of Commerce, Northwestern University, Evanston, Ill., U.S.A. $1.
The Accountant, 42 Baker St., London W. 1., England. 1 shilling.
The Controller, 1 East 42nd St., New York, N.Y. 50 cents.
Cost and Management, 66 King St. East, Hamilton, Ont. 35 cents.
Harvard Business Review, Harvard University, Boston, Mass., U.S.A. $1.50.
Journal of Accountancy, 13 East 41st St., New York, N.Y. 35 cents.
The Internal Auditor, 39 Atlantic Street, Stamford, Conn., U.S.A. $1.
National Association of Cost Accountants, 385 Madison Ave., New York. 75 cents.
Taxes—The Tax Magazine. CCH Canadian Limited, 31 Willcocks St., Toronto, Ont. $6.00 per year. (American Publication).

various types of entry have been made to meet the present high cost of fixed assets. The need for an official and unequivocal statement from the accounting profession on this subject is very apparent in the face of the present inflation in prices and the admitted responsibility of management towards owners and the public generally to preserve intact our economic capital. The American Institute points out that much thought is needed before a statement can be made, as uniform accounting standards must be upheld if the public is to maintain confidence in the integrity of audited statements. In the meantime, it is claimed that the present policy of depreciation historical cost must be adhered to and that any further amounts represent appropriations of profit. Management generally disagrees violently with this thesis. The Research Director of the Institute hints that an entirely new accounting technique, based on extensive use of price indices, may be necessary to solve the impasse.

Measurement of Profit

While accountants generally work on the basis that profit or loss is the difference between historical cost of goods sold and the revenue obtained from their sale, most of us recognize that there are two elements in profit—the "windfall" profit attributable to price changes beyond the control of management and the balance representing the "true" profit resulting from the consumer's willingness to pay more than cost to obtain the goods. In a two-part article in the 13th and 20th September issues of *'The Accountant'*, H. E. Spruce analyzes this problem from the theoretical viewpoint and develops a method for segregating the two components of profit. He then recommends that the "windfall profits" be held in a price adjustment reserve and that only "true profit" be carried to earned surplus. Here is another challenge to progressive accountants to do some constructive thinking on a problem which we have all recognized and endeavoured to ignore.

Standard Costs

"From the ordinary profit and loss account the management gleans little information as to excess costs, the delays, the wastes, the shortages and the inefficiencies which have arisen and are hindering the course of production . . . . . a routine is then established which will immedi-

ately reveal when there has been a deviation from the standard and the extent of the deviation." This quotation from the article by J. A. Scott in the 20th and 27th September and 4th October issues of *'The Accountant'* sums up the weakness of general accounting statements from the production control viewpoint and the means by which standard cost systems are designed to overcome this weakness. The article is outstanding in its clear and concise portrayal of the needs, aims and routines of standard cost systems and is particularly timely when costs and prices are racing each other up the inflationary spiral. Cost control and reduction now could mean the difference between prosperity and depression.

Study of Balance Sheets

The October issue of *'The Accounting Review'* contains an outstanding article by E. G. Nelson on the development, use and form of balance sheets, the need for flexibility if accounting is to continue to be utilitarian, and the importance of using the proper words, at all costs avoiding the mistake of Humpty-Dumpty who said "When I use a word, it means just what I choose it to mean—no more, no less." The different requirements of management, owners, investment analysts and others are also reviewed.

Internal Auditing

In many companies, advertising costs are an important item of expense and one difficult to control from the financial viewpoint. The article by E. Bailey on control and audit of advertising costs in the September issue of *'The Internal Auditor'* deals with an important subject which is covered all too seldom. Mr. Bailey discusses first the background of advertising, the normal conditions of advertising contracts and the standards of the advertising association, and these deal with the verification of agencies' billings, insertions in media, radio broadcasts, space and time rates, billings of preparatory work and publishers' discounts.

In the same issue, E. H. Cunningham has contributed an article on the form and content of the internal audit report. After dealing with the fundamentals of the report, he goes on to review oral reports, memorandum reports, letter reports, questionnaire reports and technical reports,

finishing with some remarks on report characteristics, exhibits and schedules, scope and audit comments.

Reports Prepared by the Controller

The October issue of *'The Controller'* contains a summary of the results of a questionnaire sent out to certain companies to ascertain the nature, scope, frequency and destination of reports prepared by the top financial officer. The main comments offered by these companies on reporting generally and various specific points in special reports are published and a composite schedule of reports and statements is included, giving the title of report, destination, purpose, frequency, description and comments as to value. This list is amazingly extensive and should be read by all industrial accountants who may not be fully covering their broad fields.

Preservation of Capital

The problem of inflation of capital costs is also dealt with by H. T. McAnly and W. T. Sunley in the October issue of *'The Controller'*. The effect of price inflation on capital values and the necessity for retaining "profits" in order to protect economic capital are reviewed and the old question of depreciation of replacements is once again thrashed out. The authors point out that if we recover 100-1947 dollars out of profits for depreciation in respect of 100-1937 dollars spent on plant, we have recovered only half the original cost and the business has lost 50 dollars by way of gift to its customers. These arguments, illustrated with sample financial statements, are hard to refute and there can be no doubt that accounting policies on these matters can have a vital effect on the financial condition and future stability of business generally.

Accounting Department Unions

While office unions are a comparatively new development, they are undoubtedly spreading as rank and file employees feel that a union will get them generally higher wage rates. The problems of training and promotion in the controller's department under unionized conditions are reviewed by J. H. Clawson in the October issue of *'The Controller'* and some of the pitfalls of union contracts are outlined. An entirely new technique of staff management may be necessary to meet this major change in business if it becomes widespread.

Valuation of Goodwill

An interesting judgment in a recent U.S. tax case ruled that corporate goodwill might arise solely out of the personal ability and contracts of executive-shareholders and that total goodwill value in such case should be allocated between this factor and the goodwill attaching to the business as such. The case is reviewed by L. A. Boxleitner in the October issue of *'Taxes'*.

Standard Costs

A very complete article on standard costs, by L. M. Elliott, controller of McCord Corporation, is included in the August-September issue of *'Cost and Management'*. Material standards, labour standards, overhead and cost reports are dealt with clearly and thoroughly and the author points out the advantages of standard costs and of other cost systems.

Personals

Karl Rudick, Chartered Accountant, announces the removal of his office to 477 St. Francois-Xavier Street, Room 302, Montreal, Quebec.

Saul A. Glick and William Levine, Chartered Accountants, announce that they are now carrying on their practice under the firm name of Glick and Levine, at 94 Wellington Street West, Toronto, Ontario.

C. Watson Sime, W. J. Ayers and J. E. Cunningham, Chartered Accountants, partners of Stiff Bros. & Sime, announce that after 1st December they will carry on the practice of their profession under the name Sime, Ayers & Co., Chartered Accountants, 371 Bay Street, Toronto, Ontario.

Provincial News

Regina Chartered Accountants Club

The Regina Chartered Accountants Club held their annual meeting at a luncheon October 15, 1947. The executive elected for the 1947-48 year were as follows: President, Miss Janet Robinson; Vice-President, W. A. Fowlie; Secretary-Treasurer, S. C. Dale; Members, H. A. Hunt and R. G. Harper. The retiring President, Mr. A. M. Goldie, extended congratulations on behalf of the club to Mr. T. H. Moffet, F.C.A., Dominion President Elect. The various reports for the past year indicated a successful season from the point of view of learning, sociability and even financially. During the year talks were enjoyed by the club from Mr. C. H. Smith, C.A., on the Dominion Convention; Mr. B. M. Houston on New World Bank and Fund; Mr. C. H. Cotter, C.A., on Income Tax, special reference as to Co-operatives; Mr. Louis Jacobs, F.C.A., on Municipal Auditing; and Mr. R. C. Hodsman, C.A., on Machine Accounting.

In addition, on the recreation side, a Chartered Accountant Bowling League was operated for the first time by practising firms, their staffs and other members of the profession, with no casualties reported. The League is functioning again this year with Ian Forbes as Chairman, Harold Moffet as Member, and Bert Pointer as Secretary-Treasurer.

Ontario

According to a notice received by The Dominion Association of Chartered Accountants from the Institute of Chartered Accountants of Ontario, Mr. Morris Goodman has been suspended from the membership of that Institute for a period of two years from July 28, 1947.

The Council of the Ontario Institute announces that it will give an honorarium of $50.00 to any member or registered student resident in Ontario contributing an article deemed worthy of publication by the Editorial Committee of THE CANADIAN CHARTERED ACCOUNTANT.

A London, Ontario, Chapter of the Ontario Institute and Ontario Students' Association has recently been formed and the following officers elected: Hon. President, J. W. Westervelt, C.A.; President, W. C. Benson, C.A.; Vice Presidents, J. Wigle, C.A.; K. W Anderson; Secretary, K. Jolley; Treasurer, P. Richardson.

All chartered accountants and students of the London-Strathroy-Stratford-Goderich and St. Thomas areas and neighbouring points are cordially invited to register for membership in the chapter.

Calgary Chartered Accountants' Club

The monthly meeting of the Calgary Chartered Accountants' Club was held November 19th as a Luncheon Meeting in the Renfrew Club. The following members of the club gave short talks on various sections of Bill 454, the proposed new Income Tax Act, and compared it with corresponding provisions of the present Income War Tax Act:

Norman McLean, C.A.; Horace J. Bishop, C.A.; J. G. Simonton, C.A.; Norman E. Hames, C.A.; A. Bruce Ross, C.A.; Donald J. Morrison, C.A.

Following the talks by the members, there was a general discussion amongst those present on the sections of the new bill which the speakers had brought out.

The next meeting — December 16th, will be a Dinner Meeting of members and their ladies.

In view of the interest of members in Bill 454 it is possible that the January meeting may be devoted to a further discussion of various sections of the Bill.

STUDENTS' DEPARTMENT

J. E. SMYTH, C.A., Editor

NOTES AND COMMENTS

We would not go so far as to oppose those accounting techniques by which operating results are broken down into separate profit figures for departments and/or products manufactured, but we do deplore the fact that in some hands the results lend themselves to too hasty conclusions that this or that department should be closed or that the manufacture of this or that product should be abandoned merely because one department shows a loss as compared with another's profit.

In the matter of analysis of operating results by departments each of which produces its own product, we heartily recommend a review of the solution to Question 3, Final Accounting I, December 1944 which appeared in The Students' Department of June 1945. Part (a) of this problem required a statement showing the probable accounting effect of a decision to cease manufacture of a certain type of product. Part (b) required mention of "any other factors which should be taken into account before a decision is made".

The accountant who prepared the solution drew attention to several factors in his answer to part (b) which we think are well worth recalling from time to time. He noted that the sale of the product in question may have helped indirectly the sale of the other types of product; that "travelling and similar expenses now expended for the benefit of both departments may not be reduced materially if one is discontinued"; that more efficient methods of producing the article may be developed or that future demand may shift and give it a new lease on life; that "there may be 'key' men in the organization the salaries of whom are distributed over both departments" with the result that closing one department merely shifts the burden of such charges completely on the surviving departments; that "it may be that supplies, power, fuel, etc. are now being purchased on more favourable terms than could be obtained if the consumption of these items were reduced".

It is further suggested that while the loss on disposal of the plant may be charged against the operations of the

remaining departments for the purposes of the problem, it would not be allowable for tax purposes as would be the depreciation on the plant if it remained in operation.

The data of the problem indicate still another complication: the cost of settling, prematurely, long-term contractual obligations undertaken by the department the closing of which is under consideration.

HOW ALERT ARE YOU?

An anonymous friend has placed *The Bankers' Magazine of Australasia* (August 1947) on our desk, open at a 1946 bookkeeping examination problem and its solution. It is described as one of those questions the answer to which is immediately apparent to some people but which causes others to "flounder in a bog". We take the liberty to reproduce it here (only slightly revised for our purposes) because of its moral: that an under- or overstatement of a balance sheet item can no more be ignored in its effect on the profits of the period following the balance sheet date than in its effect on the profits of the period ending on the balance sheet date—it is not only a closing figure for one period but an opening figure of the next. Besides, the problem illustrates one of our favourite topics, the relationship between the balance sheet and the income statement.

Problem:

A firm which keeps no purchases book or accounts payable ledger estimates its outstanding liability for merchandise purchases at 30th June each year. It now appears that the liability was inaccurately determined as follows:

At 30th June 1940 trade accounts payable were overstated $300.

At 30th June 1941 trade accounts payable were understated $250.

At 30th June 1942 trade accounts payable were understated $360.

At 30th June 1943 trade accounts payable were overstated $520.

At 30th June 1944 trade accounts payable were overstated $115.

At 30th June 1945 trade accounts payable were understated $60.

At 30th June 1946 trade accounts payable were correctly stated.

Required:

(a) What was the effect of these errors on the aggregate of net profits for the period July 1, 1939 to June 30, 1946?

(b) Prepare a statement to disclose the effect of the errors on the net profit of each year.

Solution:

(a) There is no effect on total net profits. Any period which commences with a correct statement of assets and liabilities (which may be assumed to be the case at July 1, 1939) and which ends with a correct statement of assets and liabilities must show a correct figure for profits.

(b)

	Trade accounts payable				Net profits	
	30th June		1st July			
	Over-stated	Under-stated	Over-stated	Under-stated	Over-stated	Under-stated
1940 ...	$300					$300
1941 ...		$250	$300		$550	
1942 ...		360		$250	110	
1943 ...	520			360		880
1944 ...	115		520		405	
1945 ...		60	115		175	
1946 ...				60		60
					$1,240	$1,240

Total overstatement of profits	$1,240
Total understatement of profits	1,240
Net effect on total profits	NIL

PROBLEMS AND SOLUTIONS

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

CORRECTION—NOVEMBER STUDENTS' DEPARTMENT

We very much regret an error in the statement of problem II, Final examination, December 1946, Accounting III, Question 3 which appeared on page 317 of the November issue of THE CANADIAN CHARTERED ACCOUNTANT. The last item among the assets of the estate at April 1, 1946 should read, "Shares in Industrial Coys. $8,000." instead of "Shares in Industrial Coys. $80,000".

PROBLEM I

INTERMEDIATE EXAMINATION, DECEMBER 1946

Accounting I, Question 6 (15 marks)

In a statement of application of funds how would you treat depreciation provided, bond discount amortized and organization expenses incurred during the accounting period? Illustrate your answer with a typical statement of application of funds using your own figures.

SOLUTION

In a statement of application of funds both depreciation provided and bond discount amortized would be added back to net profit for the period as neither involves a decrease in working capital in that period. The organization expenses incurred during the period would be shown as an application of funds, assuming that this item has been capitalized. Although cash was expended during the period, the amount of the organization expenses would not ordinarily be charged to operations.

The following shows how these three items would appear in a statement of application of funds:

Source of funds			
Net profit for the year ended December 31, 1945		$100,000.00	
Add back charges to operations not involving a depletion of working capital:			
Depreciation	$20,000.00		
Bond discount amortized	10,000.00		
		30,000.00	
			$130,000.00
Application of funds			
Outlays not charged to operations which involve a depletion of working capital during period:			
Plant and equipment purchased		$30,000.00	
Organization expenses		5,000.00	
			35,000.00
Increase in working capital, per statement attached			$ 95,000.00

STATEMENT OF COMPARATIVE WORKING CAPITAL
as at December 31, 1945 and 1944

	December 31 1945	December 31 1944	Working Capital Increase or decrease
Current Assets			
Cash	$ 50,000.00	$ 40,000.00	$ 10,000.00 I
Accounts receivable	200,000.00	150,000.00	50,000.00 I
Inventories	140,000.00	80,000.00	60,000.00 I
	$390,000.00	$270,000.00	$120,000.00 I
Current Liabilities			
Bank loan	$100,000.00	$120,000.00	$ 20,000.00 I
Accounts payable	145,000.00	100,000.00	45,000.00 D
	$245,000.00	$220,000.00	$ 25,000.00 D
Increase in working capital	$145,000.00	$ 50,000.00	$ 95,000.00

PROBLEM II

FINAL EXAMINATION, DECEMBER 1946

Accounting IV, Question 1 (35 marks)

The Aztec Manufacturing Co. Ltd. is a Canadian company with a branch office at Chicago, Ill. Trial balances of the head office and branch at 30th June 1946 and supplementary information are as follows:

HEAD OFFICE TRIAL BALANCE, 30TH JUNE 1946

Cash at bank	$ 35,000	
Accounts receivable	57,000	
Chicago branch control	38,750	
Inventories, 1st July 1945:		
Raw materials	39,000	
Goods in process	16,000	
Finished goods	40,000	
Land	20,000	
Factory buildings	80,000	
Factory machinery and equipment	135,000	
Furniture and fixtures	15,000	
Reserve for depreciation		$ 90,000
Accounts payable		48,000
Wages accrued		8,000
Share capital		200,000
Earned surplus—1st July 1945		92,500
Foreign exchange fluctuations	1,250	
Sales		600,000
Raw materials purchased	355,000	
Manufacturing labour—direct	190,000	
Manufacturing expense	132,500	
Selling expense	59,000	
General expense	45,000	
Finished goods shipped to Chicago branch—at cost		220,000
	$1,258,500	$1,258,500

CHICAGO BRANCH TRIAL BALANCE, 30TH JUNE 1946

	United States Funds	
Cash at bank	$ 4,000	
Accounts receivable	25,000	
Inventory, 1st July 1945	20,000	
Furniture and fixtures	3,000	
Reserve for depreciation—furniture and fixtures		$ 1,500
Accounts payable		4,500
Sales		300,000
Goods received from head office	200,000	
Freight and duty on goods from head office	35,000	
Selling expense	30,000	
General expense	24,000	
Head office account		35,000
	$ 341,000	$ 341,000

The inventories as at 30th June 1946 were as follows:

Head office:		
Raw materials	$ 46,000	
Goods in process	26,000	
Finished goods	60,000	
Chicago branch:		(U.S.
Merchandise	32,000	funds)

No remittances and no merchandise were in transit between the head office and branch as at 30th June 1946.

Depreciation for the year ended 30th June 1946 should be provided, in the accounts of both the head office and the branch, at the following rates applied to the closing balances in the asset accounts:

Buildings	5% per annum
Machinery and equipment	10% per annum
Furniture and fixtures	10% per annum

Particulars of the Chicago branch furniture and fixtures account and the reserve for depreciation therefor, are as follows:

	Furniture and Fixtures	Reserve for Depreciation
Purchases in 1938	$2,000	$1,400
Purchases in July 1944	1,000	100
	$3,000	$1,500

For the purposes of this problem, it is to be assumed that the rates of exchange for the United States dollar were as follows:

At time of purchase of furniture and fixtures in 1938	at par
At time of purchase of furniture and fixtures in 1944	$1.11
At 1st July 1945	1.11
Average rate for the year ended 30th June 1946	1.10
At 30th June 1946	1.10

It is the practice of the company to carry forward foreign exchange fluctuations in its accounts.

All fixed assets and inventories are stated at cost.

Income and excess profits taxes are to be ignored.

Required:

From the trial balances and supplementary information furnished above you are required to prepare, in Canadian currency:

(a) The company's balance sheet at 30th June 1946, showing only combined totals of the accounts of the head office and branch.

(b) Statement of profit and loss for the year ended 30th June 1946, showing, in columnar form, the operations of the head office and the branch as well as the combined totals.

(c) Statement of cost of goods manufactured for the year ended 30th June 1946.

SOLUTION

CONVERSION OF CHICAGO BRANCH TRIAL BALANCE
30th JUNE 1946

	United States funds		Rate	Canadian funds	
Cash at bank	$ 4,000		$1.10	$ 4,400	
Accounts receivable	25,000		1.10	27,500	
Inventory, 1st July 1945	20,000		1.11	22,200	
Furniture and fixtures	3,000		as below	3,110	
Reserve for depreciation—furniture and fixtures		$ 1,500	as below		$ 1,511
Accounts payable		4,500	1.10		4,950
Sales		300,000	1.10		330,000
Goods received from head office	200,000		per H.O. accounts	220,000	
Freight and duty	35,000		1.10	38,500	
Selling expense	30,000		1.10	33,000	
General expense	24,000		1.10	26,400	
Head office account		35,000	per H.O. accounts		38,750
	$341,000	$341,000		$375,110	$375,211
Exchange fluctuations				101	
				$375,211	$375,211

DEPRECIATION

Furniture and Fixtures	U.S. funds	Exchange Rate	Can. funds	Depreciation Reserve 1st July 1945 U.S. funds	Depreciation Reserve 1st July 1945 Can. funds	Provision 1946 @ 10% U.S. funds	Provision 1946 @ 10% Can. funds
Additions 1938	$2,000	$1.00	$2,000	$1,400	$1,400	$200	$200
Additions 1944	1,000	1.11	1,110	100	111	100	111
	$3,000		$3,110	$1,500	$1,511	$300	$311

Merchandise inventory 30th June 1946 $32,000 (U.S.) at current rate of 1.10 =$35,200 (Can.)

(a)

AZTEC MANUFACTURING CO. LTD.
BALANCE SHEET AS AT 30th JUNE 1946

ASSETS

CURRENT ASSETS:			
Cash at bank		$ 39,400	
Accounts receivable		84,500	
Inventories, at cost—			
Finished goods	$ 95,200		
Goods in process	26,000		
Raw materials	46,000	167,200	$291,100
FIXED ASSETS:			
Land		$ 20,000	
Buildings	$ 80,000		
Machinery and equipment	135,000		
Furniture and fixtures	18,110		
	$233,110		
Less—			
Reserve for depreciation	110,822	122,288	142,288
DEFERRED CHARGES:			
Foreign exchange fluctuations			1,351
			$434,739

LIABILITIES

CURRENT LIABILITIES:			
Accounts payable		$ 52,950	
Wages accrued		8,000	$ 60,950
CAPITAL AND SURPLUS:			
Share capital		$200,000	
Earned surplus—			
Balance as at 1st July 1945	$ 92,500		
Net profit for the year ended 30th June 1946—per statement attached	81,289	173,789	373,789
			$434,739

(b)

AZTEC MANUFACTURING CO. LTD.
STATEMENT OF PROFIT AND LOSS
FOR THE YEAR ENDED 30th JUNE 1946

	Head Office	Chicago Branch	Total
Sales	$600,000	$330,000	$930,000
Cost of sales—			
Inventory of finished goods— 1st July 1945	$ 40,000	$ 22,200	$ 62,200
Cost of goods manufactured (per statement attached)	678,000	—	678,000
Cost of goods shipped to Chicago branch	*220,000*	220,000	
Freight and duty	—	38,500	38,500
	$498,000	$280,700	$778,700
Deduct—			
Inventory of finished goods— 30th June 1946	60,000	35,200	95,200
	$438,000	$245,500	$683,500
Gross profit	$162,000	$ 84,500	$246,500
Deduct—			
Selling expenses	$ 59,000	$ 33,000	$ 92,000
General expense	45,000	26,400	71,400
Depreciation—furniture and fixtures	1,500	311	1,811
	$105,500	$ 59,711	$165,211
Net profit for the year	$ 56,500	$ 24,789	$ 81,289

(c)

AZTEC MANUFACTURING CO. LTD.
STATEMENT OF COST OF GOODS MANUFACTURED
FOR THE YEAR ENDED 30TH JUNE 1946

Inventory of goods in process—1st July 1945		$ 16,000
Raw materials used:		
Inventory—1st July 1945	$ 39,000	
Purchases	355,000	
	$394,000	
Less—		
Inventory—30th June 1946	46,000	348,000
Direct labour		190,000
Manufacturing expense:		
Depreciation—		
Building (5% on $80,000)	$ 4,000	
Machinery and equipment (10% on $135,000.)	13,500	
	$ 17,500	
Other manufacturing expense	132,500	150,000
		$704,000
Deduct—		
Inventory of goods in process—30th June 1946		26,000
Cost of goods manufactured		$678,000

300